INTRODUCTION

An appraisal of lending and collection policies, the bank's adherence thereto, and the evaluation of individual loans are among the most important aspects of the examination process. To a great extent, it is the quality of a bank's loan portfolio that determines the risk to depositors and to the FDIC's insurance fund. Conclusions regarding the condition of the bank and the quality of its management are weighted heavily by the examiner's findings with regard to lending practices. Emphasis on review and appraisal of the loan portfolio and its administration by bank management during examinations recognizes, first, that loans comprise a major portion of the asset structures of most banks, and, second, that it is the asset category which ordinarily presents the greatest credit risk and, therefore, potential loss exposure to banks. Moreover, pressure for increased profitability, liquidity considerations, and a vastly more complex society have produced great innovations in credit instruments and approaches to lending. Loans have consequently become much more complex. Examiners therefore find it necessary to devote a large portion of their time and attention to examination of bank loan portfolios.

I. LOAN ADMINISTRATION

Lending Policies

The examiner's evaluation of the loan portfolio involves much more than merely appraising the individual loans therein. Prudent management and administration of the overall loan account, including establishment of sound lending and collection policies, are of vital importance if the bank is to be continuously operated in an acceptable manner.

Lending policies should be clearly defined and set forth in such a manner as to provide effective supervision by the directors and senior officers. Inasmuch as the board of directors of every bank has the legal responsibility to formulate lending policies and to supervise their implementation, examiners should encourage establishment and maintenance of written, up-to-date lending policies which have been approved by the board of directors. A bank's lending policy should not be a static document, but must be reviewed periodically and revised in light of changing circumstances surrounding the borrowing needs of the bank's customers as well as changes that may occur within the bank itself. To a large extent, the economy of the community served by the bank dictates the composition of the loan account. The widely divergent circumstances of regional economies and the considerable variance in characteristics of individual loans preclude establishment of standard or universal lending policies. There are, however, certain broad areas of consideration and concern that should be addressed in the lending policies of all banks regardless of size or location. These include the following, as minimums:

1. General fields of lending in which the bank will engage and the kinds or types of loans within each general field;
2. Lending authority of each loan officer;
3. Lending authority of a loan or executive committee, if any;
4. Responsibility of the board of directors in reviewing, ratifying, or approving loans;
5. Guidelines under which unsecured loans will be granted;
6. Guidelines for rates of interest and the terms of repayment for secured and unsecured loans;
7. Limitations on the amount advanced in relation to the value of the collateral and the documentation required by the bank for each type of secured loan;
8. Guidelines for obtaining and reviewing real estate appraisals as well as for ordering reappraisals, when needed;
9. Maintenance and review of complete and current credit files on each borrower;
10. Appropriate and adequate collection procedures including, but not limited to, actions to be taken against borrowers who fail to make timely payments;
11. Limitations on the maximum volume of loans in relation to total assets;
12. Limitations on the extension of credit through overdrafts;
13. Description of the bank's normal trade area and circumstances under which the bank may extend credit outside of such area;
14. Guidelines, which at a minimum, address the goals for portfolio mix and risk diversification and cover the bank's plans for monitoring and taking appropriate corrective action, if deemed necessary, on

any concentrations that may exist;
15. Guidelines addressing the bank's loan review and grading system ("Watch list"); and
16. Guidelines addressing the bank's review of the Allowance for Loan Losses.
17. *Guidelines for adequate safeguards to minimize potential environmental liability.*

The above are designed to serve only as guidelines for areas needing consideration in overall policy evaluation. Examiners should also encourage management to develop specific guidelines for each lending department or function. As with overall lending policies, it is not the FDIC's intent to suggest universal or standard loan policies for specific types of credit. The establishment of these policies is the responsibility of each bank's board of directors and management. Therefore, the following discussion of basic principles applicable to various types of credit will not include or allude to acceptable ratios, levels, comparisons or terms. These matters should, however, be addressed in each bank's lending policy, and it will be the examiner's responsibility to determine whether the policies are realistic and being followed.

Much of the rest of this section of the Manual discusses areas that should be considered in the bank's lending policies. Guidelines for their consideration are discussed under the appropriate areas.

Loan Review Systems ("Watch-lists")

Many, if not most, banks maintain a so-called "watch-list" of loans identified by management as warranting special attention for a variety of reasons bearing on ultimate collectability. These lists represent a valuable management tool since they help focus attention and effort where they are most needed and reflect favorably on management when complete and well-documented. The lists also serve as a valuable double-check for examiners who can compare the results of their own loan review with the loans identified by management as warranting special attention and can facilitate the evaluation of the adequacy of the loan loss reserve. Finally, watch-lists proven reliable in the past can be used to help define the scope of an examination.

All insured nonmember banks should be encouraged to establish and maintain a written watch-list of loans meriting special attention. The nature and extent of the review, identification and follow-up process will vary with the size and complexity of the bank. In a small bank, the process may consist of nothing more than the CEO or loan officer(s) identifying which loans merit special attention, the reasons why such attention may be necessary and periodically reporting on the status of the identified loans to the board of directors. In a larger bank, the function may be performed by a separate loan review staff responsible for conducting periodic credit reviews of all loans.

Whichever way a bank may choose to organize the function, the process should include at a minimum the following elements:

1. An identification or grouping of loans that warrant the special attention of management;

2. For each loan identified, a statement or indication of the reason(s) why the particular loan merits special attention; and

3. A mechanism for reporting periodically to the board of directors on the status of each loan identified and the actions(s) taken by management.

Any bank that has not established or fails to maintain a "watch-list" program meeting these minimum requirements should be encouraged to do so and any deficiency noted should receive critical comment on page eight of the examination report, Administration, Supervision, and Control and on page one of the examination report as the circumstances may require.

II. PORTFOLIO COMPOSITION

Commercial Loans

<u>General</u>

Loans for commercial or industrial purposes to business enterprises, whether proprietorships, partnerships or corporations, are commonly described by the term "commercial loans". In asset distribution, commercial or business loans frequently comprise one of the most important assets of a bank. They may be secured or unsecured and for short or long-term maturities. Such loans include working capital advances, term loans and loans to individuals for business purposes.

Short-term working capital and seasonal loans provide temporary capital in excess of normal needs. They are used to finance seasonal requirements and are repaid at the end of the cycle by converting inventory and accounts receivable into cash. Such loans may be unsecured, however, many working capital loans are advanced with accounts receivable and/or inventory as collateral. Firms engaged in manufacturing, distribution, retailing and service-oriented businesses use short-term working capital loans.

Term business loans have assumed increasing importance. Such loans normally are granted for the purpose of acquiring capital assets, such as plant and equipment. Term loans may involve a greater risk than do short-term advances, because of the length of time the credit is outstanding. Because of the potential for greater risk, term loans are usually secured and generally require regular amortization. Loan agreements on such credits may contain restrictive covenants during the life of the loan. In some instances, term loans may be used as a means of liquidating, over a period of time, the accumulated and unpaid balance of credits originally advanced for seasonal needs. While such loans may reflect a borrower's past operational problems, they may well prove to be the most viable means of salvaging a problem situation and effecting orderly debt collection.

A bank's commercial lending policies should address at least acquisition of credit information such as property, operating and cash flow statements, factors that might determine the need for collateral acquisition, acceptable collateral margins, perfecting liens on collateral, lending terms, and charge-offs.

Accounts Receivable Financing

Accounts receivable financing is a specialized area of commercial bank lending in which borrowers assign their interests in accounts receivable to the lender as collateral. Typical characteristics of accounts receivable borrowers are those businesses that are growing rapidly and need year-round financing in amounts too large to justify unsecured credit, those that are nonseasonal and need year-round financing because working capital and profits are insufficient to permit periodic cleanups, those whose working capital is inadequate for the volume of sales and type of operation, and those whose previous unsecured borrowings are no longer warranted because of various credit factors.

Several advantages of accounts receivable financing from the borrower's viewpoint are: it is an efficient way to finance an expanding operation because borrowing capacity expands as sales increase; it permits the borrower to take advantage of purchase discounts because the company receives immediate cash on its sales and is able to pay trade creditors on a satisfactory basis; it insures a revolving, expanding line of credit; and actual interest paid may be no more than that for a fixed amount unsecured loan.

Advantages from the bank's viewpoint are: it generates a relatively high yield loan, new business, and a depository relationship; permits continuing banking relationships with long-standing customers whose financial conditions no longer warrant unsecured credit; and minimizes potential loss when the loan is geared to a percentage of the accounts receivable collateral.

Although accounts receivable loans are collateralized, it is important to analyze the borrower's financial statements. Even if the collateral is of good quality and in excess of the loan, the borrower must demonstrate financial progress. Full repayment through collateral liquidation is normally a solution of last resort.

Banks use two basic methods to make accounts receivable advances. First, blanket assignment, wherein the borrower periodically informs the bank of the amount of receivables outstanding on its books. Based on information, the bank advances the agreed percentage of the outstanding receivables. The receivables are usually pledged on a non-notification basis and payments on receivables are made directly to the borrower who then remits them to the bank. The bank applies all or a portion of such funds to the borrower's loan. Second, ledgering the accounts, wherein the lender receives duplicate copies of the invoices together with the shipping documents and/or delivery receipts. Upon receipt

of satisfactory information, the bank advances the agreed percentage of the outstanding receivables. The receivables are usually pledged on a notification basis. Under this method, the bank maintains complete control of the funds paid on all accounts pledged by requiring the borrower's customer to remit directly to the bank.

In the area of accounts receivable financing, a bank's lending policy should address at least the acquisition of credit information such as property, operating and cash flow statements. It should also address maintenance of an accounts receivable loan agreement that establishes a percentage advance against acceptable receivables, a maximum dollar amount due from any one account debtor, financial strength of debtor accounts, insurance that "acceptable receivables" are defined in light of the turnover of receivables pledged, aging of accounts receivable, and concentrations of debtor accounts.

Highly Leveraged Transaction (HLTs)

The three Federal banking agencies have jointly adopted a common definition of HLTs. For supervisory purposes, a bank or bank holding company is considered to be involved in an HLT when credit is extended or investment is made in a business where the financing transaction involves the buyout, acquisition, or recapitalization of an existing business. In addition to the purpose test, one of the following criteria must be met for the transaction to be considered an HLT.

- *The transaction at least doubles the subject company's liabilities and results in a leverage ratio higher than 50%.*
- *The transaction results in a leverage ratio higher than 75%.*
- *The transaction is designated an HLT by a syndication agent.*

In those cases where a credit meets the purpose test but is not covered by any of the criteria above, the bank supervisory agencies may nevertheless designate the credit as an HLT. It is anticipated that this would be done infrequently and only in material cases.

Total exposure to individual HLT borrowers includes all loans, extensions of credit, and debt and equity securities relating to acquisitions or restructuring transactions as well as any ordinary business loans to or investments in, the same obligor. Total exposure also includes standby letters of credit, legally binding contractual commitments, and other financial guarantees. *The agencies will include all obligations of, and claims on, HLT borrowers, regardless of perceived credit quality or secured status.*

The leverage ratio for these purposes is total liabilities divided by total assets. **Total liabilities include all forms of debt and claims, including all subordinated debt and non-perpetual preferred stock. Total assets include intangible assets.**

General Policy Statement - If a bank intends to engage in HLT financing, examiners should determine whether the bank's board of directors has adopted a written policy statement that clearly defines a HLT, as well as the bank's overall philosophy and objectives in financing HLTs. The policy should include:

1. **The purpose and use of such financing;**
2. **Permissible lending and investment activities;**
3. **Identification of industries suited for such financing;**
4. **A recognition of the unique characteristics and risks associated with high levels of leveraging;**
5. **A broad-based definition that captures the essence of HLTs and includes all credits and investments with similar characteristics and levels of risk;**
6. **In-house limits relative to capital on exposure for individual credits, specific industries, and the aggregate portfolio, to be reviewed at least annually by the board;**
7. **A recognition of the need for independent credit reviews and assessments and management information systems (MIS) to monitor performance;**
8. **A recognition of the need for well-defined standards and separate, specific guidelines**

for policy, approval, and review of HLT transactions; and

9. An acknowledgment that all HLT-related fees, which may be large and take various forms, are to be recognized in accordance with Generally Accepted Accounting Principles, unless otherwise specified in the Call Report instructions. The policy should recognize the accounting requirements for fees set forth in FASB 91.

Examiners should determine whether the board has approved a separate policy for approving and reporting on HLTs. Such a policy should supplement policies used in the normal credit process. It should ensure that all loans identified as HLTs are reviewed and approved through a separate and distinct process. To determine adherence, examiners should review the internal listing of HLTs and ensure that it captures all financing with similar levels of risk (e.g., LBOs, recapitalizations, cashouts, etc.). If some credits related to HLTs are not included, examiners should determine the reasons for, and the significance of, omissions.

The lending policy should include:

1. Control features that specifically recognize complex loan structuring, collateral arrangements or other unique features of these credits;

2. Reporting system type and frequency;

3. Minimum risk ratings and underwriting criteria, such as standards for cash flow coverage and other repayment sources;

4. Pricing considerations;

5. Legal review requirements;

6. Requirements for review by asset sales and distribution personnel;

7. Requirements for interest rate protection; and

8. Requirements for, at a minimum, a semiannual review of the portfolio by line management.

Portfolio Analysis and Management Information System (MIS) - Examiners should determine whether a separate, specific MIS and analysis process has been established as part of the overall management and control of HLT financing. The process should be sufficiently detailed to provide management and the board with periodic information on the overall size, quality and performance of the HLT portfolio.

Examiners should review all MIS and reporting system date on HLTs. The system should provide the following information and analysis.

1. Concentration by industry and type of financing, e.g., leveraged buyout, recapitalization, cashout, etc.;

2. Comparisons of current aggregate HLT exposure and significant additions to, and deletions from, previous totals;

3. Information by originator;

4. Risk rating of portfolio and significant changes in risk rating of aggregates and individual items;

5. Portfolio aging and performance relative to expectations; and

6. A list of all refinancings and restructured transactions.

Distribution and Participations - Asset sales, participations, syndication and other means of distribution are critical elements in the rapid growth of HLT financing. Many banks have a stated goal of creating assets and redistributing them to limit their risks by diversifying their portfolios. Both the lead and purchasing banks are expected to adopt formal policies and procedures on sales and distribution of participations in HLT financing. Management and the board should be familiar with applicable regulatory guidelines governing asset participations, purchases and sales, and should ensure full compliance with those guidelines.

Examiners should review all policies and procedures that relate to HLT-related asset sales, distribution and syndication efforts. The policies should include:

1. Credit standards and an approval process for counterparty risk;

2. An approved customer list;

3. Sell-down guidelines and disclosure requirements;

4. Repurchase guidelines;

5. MIS and other reporting requirements;

6. Controls on incentive or commission programs; and

7. Accounting guidelines for such items as "strip" sales, fees and revaluation of assets.

Internal Reviews - Independent assessments of the HLT portfolio are an important part of an institution's overall control and MIS process. The unique characteristics and risks of these loans make early detection of emerging trends and potential problems essential. Examiners should assess the nature and extent of the bank's HLT review and control process. At a minimum, the process should provide for an annual review of all HLT credits as a separate portfolio. This process should supplement the bank's normal management review process for the loan portfolio. The review should include:

1. Assessment of aggregate portfolio, industry and individual transaction limit;

2. Testing and reaffirmation of underwriting criteria;

3. Testing for compliance with policy and procedures;

4. Testing of individual risk ratings;

5. Assessment of aggregate risk rating levels and trends;

6. Assessment of significant additions to and deletions from the HLT portfolio;

7. Assessment of industry concentrations;

8. Identification of emerging trends and potential problems; and

9. Review of individual HLTs to ensure that covenants are being adhered to.

Equity Investments - A number of banking organizations, primarily but not exclusively the multi-national banking companies, have direct and/or indirect equity investments in HLTs. Intense competition for business has led banking companies to provide or arrange financing for all aspects of a proposed transaction, including equity positions. Equity investments have been made by Small Business Investment Corporations owned by banks, bank holding companies and their affiliates. Indirect investments have been acquired through investment in specialized funds (LBO funds) whose sole purpose is to provide financing for HLTs for their own accounts. Banks generally have not made direct equity investments or investments in LBO funds. Equity investments generally involve higher levels of risk than either senior or junior debt and where permitted should be governed by adequate policies, procedures, controls and MIS. At a minimum, policies should establish an approval and review process for such activities.

Mezzanine Financing - Mezzanine financing represents those parts of an HLT's financing package that are neither equity nor senior debt. It usually is extended through subsidiaries of banks or nonbank subsidiaries of bank holding companies. Examiners should review policies for mezzanine financing to ensure that they generally include:

1. Limits for both aggregate volume and individual transaction;

2. Designated booking units;

3. Credit approval and reporting processing;

4. MIS and other reporting requirements;

5. An internal risk rating system and requirements for periodic reviews; and

6. Procedures for legal review of HLTs.

Allowance for Loan and Lease Losses - The potential impact of a bank's participation in financing HLTs should be carefully considered when reviewing the adequacy of the allowance for loan and lease losses (ALLL). The aggregate size and overall condition of the HLT portfolio should be specifically addressed in any review of the overall adequacy of the allowance. Examiners should review the bank's methodology for incorporating the special risks related to HLT financing in its determination of the adequacy of ALLL. Management's internal risk rating system is expected to include assessment of its equity and mezzanine financing portfolio in determining the need for valuation reserves.

Legal Reviews and Potential Conflicts of Interest - Examiners should determine whether a bank's board of directors and management have established policies on HLTs to minimize risks posed by potential legal and conflict-of-interest issues. Policies should provide for legal review of all bank involvement with HLTs to determine that they are permissible for banking organizations and to address potential conflicts of interest. Several examples illustrate this point:

> Conflicts of Interest - Conflicts of interest may arise when a banking company is involved in financing a transaction and takes an equity interest in the transaction. When a banking company plays multiple roles in connection with an HLT, the interests of different customers, or the interests of the bank and its customers, may conflict.
>
> Equitable Subordination - If a bank as senior lender exercises some measures of management control, a court could rank the bank's interest on a par with those of junior creditors. A bank may be more vulnerable to this risk if its holding company is also participating in the mezzanine and/or equity financing of an HLT.
>
> Securities Laws - Equity interests and certain debt instruments used in HLTs may constitute "securities" for purposes of federal laws. When securities are involved, bank's should ensure compliance with applicable securities law requirements, including disclosure and regulatory requirements. Banks should also establish procedures to restrict the internal dissemination of material nonpublic information about an HLT to persons who are involved in the transaction.

Concentration of Credit - Aggregating all HLT transactions together as a concentration in an institution has analytical merit because high leverage entails high risk. The evaluation of a bank with an HLT concentration should carefully consider the potential effect of increased rates on the payment ability of the borrowers and thus the effect on the bank. However, mitigating factors should also be considered. HLTs can be diversified among industries that respond differently to economic cycles. Risk also can be diversified by holding small pieces of numerous HLT deals rather than concentrating exposure in a few transactions.

In addition to reviewing the total volume of a banking organization's HLTs, examiners should assess the extent to which the organization's income includes fees and commissions relating to HLTs. Examiners should also take into account the extent to which income includes gains on the sale of equity holdings. When listing HLT concentrations in reports of examination, the degree of criticism accorded, if any, will depend on the individual bank's circumstances, including: the diversification within the HLT portfolio; the quality of the individual credits; the general level of other risks in the bank; management expertise; policies and internal controls; management's demonstrated ability to conduct an independent credit analysis of each transaction; and the capital and earnings capacity of the bank. Banks that do not have the expertise to conduct in-house independent credit analyses of HLTs should not be engaging in, or buying participations in, such transactions.

Evaluating Individual Credits - In evaluating individual loans and credit files, particular attention should be addressed to: 1) the overall performance and profitability of the industry over time, including during periods of economic or financial adversity; 2) the history and stability of the borrower's market share, earnings and cash flow, particularly over the most recent business cycle and the last economic downturn; 3) the reasonableness of earnings and cash flow projections; 4) the relationship between the borrowing company's projected cash flow and debt service requirements and the resulting margin of debt service coverage; and 5) the reliability and stability of collateral scenarios, and the adequacy of collateral coverage.

Because collateral functions as a secondary repayment source in the event repayment plans go awry, industries without meaningful tangible assets, such as the service sector, all other things being equal, contain an incremental degree of risk. Such industries need not be excluded from HLT financing, but the absence of comfort provided by tangible assets that can be liquidated should be factored into the credit evaluation process.

Particular attention should be paid to the adequacy of a borrower's cash flow. Banking organizations should make an independent and realistic assessment of the borrower's cash flow projections under varying economic and interest rate assumptions, including a worst case scenario, and be able to demonstrate that they have taken into account the potential effects of an economic downturn on a borrower's cash flow and collateral values before becoming involved in an HLT. A loan whose repayment is not predicated on an identifiable and historically stable source of cash flow has speculative qualities. Reliance for loan repayment on the sale of assets or subsidiaries whose values are not clearly supported by a historically demonstrated ability to produce adequate cash flow, a firm sales contract or "take-out" commitment, or a realistic cash-generating capacity based on current economic conditions, is an inappropriate banking practice that could expose a bank to undue risks. Such loans should receive careful supervisory scrutiny and, under normal circumstances,
should be subject to examiner comment or criticism. Ordinarily, unless conservatively projected cash inflows provide a reasonable margin above the total debt service requirements and other fixed expenditures of the borrower, classification of the credit is appropriate.

When the proceeds of assets sales play an important role in reducing the debt, the methods used to determine asset valuations and projected sale proceeds should be carefully scrutinized. In addition, asset collateral coverage should be reassessed periodically throughout the life of the debt, and actual sales proceeds should be compared to projections made at origination of the HLT in order to monitor the reasonableness of the lender's assumptions concerning valuations. Repayment programs should specify the sources and timing of repayment, and any significant deviations from the programs should be evaluated. The amount of senior debt in relation to total financing should be carefully reviewed. In general, a bank's risk can be reduced if its position is senior to all other levels of debt and secured by a first lien on assets or all the stock of the borrower's operating entities. Ideally, the debt structure should permit the borrower to suspend payments on junior debt should circumstances so warrant. Special attention should be given to the risks associated with short-term bridge financing in connection with highly-leveraged restructurings. Such risks may be greater than normal because these loans are typically subordinated to other debt, may not be collateralized, and depend on the successful marketing of longer term securities or the sale of assets for repayments.

Oil and/or Gas Reserve-Based Loans

These guidelines apply to oil and/or gas reserve-based loans that are considered collateral dependent and are devoid of repayment capacity from other tangible sources.

The initial step to assessing the credit worthiness of reserve-based loans is an analysis of the engineering function. Cash flow generated from the future sale of encumbered oil and/or gas reserves is the primary, and in most cases the only intended, source of repayment. Therefore, the integrity of engineering data that depicts that future cash stream is critical to the initial lending decision and equally important to an examiner in the assessment of credit quality. For evaluation purposes, an acceptable engineering report must be an independent, detailed analysis of the reserve prepared by a competent engineering group. The report must address three critical concerns: (i) pricing; (ii) discount factors; and (iii) timing. In those cases where the engineering reports do not meet one or more of these criteria, the examiner may need to use other methods, e.g., recent cash flow histories, to determine the current collateral value.

The extent of examiner analysis is a matter of judgment, but comprehensive analysis of the credit should definitely take place if: (i) The loan balance exceeds 65% of the discounted present worth of future net income (PWFNI) of proved developed producing properties (PDP), or the cash flow analysis indicates that the loan will not amortize over four to five years; (ii) The credit is not performing in accordance with terms or repayment of interest and/or principal; or (iii) The credit is identified by the bank as a "problem" credit.

After performing the analysis, the examiner must determine if classification is warranted. The following guidelines are to be applied in instances where the obligor is devoid of primary and secondary repayment capacity or other reliable means of repayment, with total support of the debt provided solely by the pledged collateral: (i) 65% of discounted PWFNI should be classified Substandard. A lesser percentage or less severe criticism may be appropriate in cases where a reliable alternate means of repayment exists for a portion of the debt. The 65% percentage should be used when the discounted PWFNI is determined using historical production data. When less than 75% of the reserve estimate is determined using historical production data, or the discounted PWFNI is predicated on engineering estimates of the volume of oil/gas flow (volumetric and/or analogy-based engineering data), the collateral value assigned to Substandard should be reduced accordingly. (ii) The balance, but not more than 100% of discounted PWFNI of PDP reserves, should be classified Doubtful. (iii) Any remaining deficiency balance should be classified Loss.

In addition to PDP, many reserve-based credit collateral values will include items variously referred to as proved (or proven) developed non-producing reserves, shut-in reserves, behind-the-pipe reserves and proved undeveloped properties (PUP) as collateral. Due to the nature of these other reserves, there are no strict percentage guidelines for the proportion of the credit supported by this type of collateral that should remain as a bankable asset. However, only in very unusual situations would the proportion of collateral values for these other reserves assigned to a classification category approach values for PDP.

The examiner must ascertain the current status of each reserve and develop an appropriate collateral value. Examples could be reserves that are shut-in due to economic conditions versus reserves that are shut-in due to the absence of pipeline or transportation. PUP require careful evaluation before allowing any bankable collateral value.

Real Estate Loans

General

Real estate loans (loans principally secured by liens on real property) are part of the loan portfolios of almost all commercial banks. Real estate loans include credits advanced for the purchase of real property. However, the term may also encompass extensions granted for other purposes, but for which primary collateral protection is real property.

The degree of risk in a real estate loan depends primarily on the loan amount in relation to collateral value, the interest rate, and most importantly, the borrower's ability to repay in an orderly fashion. It is extremely important that a bank's real estate loan policy ensure that loans are granted with the reasonable probability the debtor will be able and willing to meet the payment terms. Placing undue reliance upon a property's appraised value in lieu of an adequate initial assessment of a debtor's repayment ability is a potentially dangerous mistake.

Historically, many banks have jeopardized their capital structure by granting ill-considered real estate mortgage loans. Apart from unusual, localized, adverse economic conditions which could not have been foreseen, resulting in a temporary or permanent "wash out" of realty values, the principal errors made in granting real estate loans include inadequate regard to normal or even depressed realty values during periods when it is in great demand thus inflating the price structure, mortgage loan amortization, the maximum debt load and paying capacity of the borrower, and failure to reasonably restrict mortgage loans on properties for which there is limited demand.

A principal indication of a troublesome real estate loan is an improper relationship between the amount of the loan, the potential sale price of the property, and the availability of a market. The potential sale price of a property may or may not be the same as its appraised value. The current potential sale price or liquidating value of the property is of primary importance and the appraised value is of secondary importance. There may be little or no current demand for the property at its appraised value and it may have to be disposed of at a sacrifice value.

Examiners must appraise not only individual mortgage loans, but also the overall mortgage lending and administration policies of the bank to ascertain the soundness of its mortgage loan operations as well as the liquidity contained in the account. The bank should establish policies that address the following factors: the maximum amount that may be loaned on a given property, in

a given category, and on all real estate loans; the need for appraisals (professional judgments of the present and/or future value of the real property) and for amortization on certain loans.

Real Estate Lending Standards

Section 18(o) of the FDI Act requires the Federal banking agencies to adopt uniform regulations prescribing standards for loans secured by liens on real estate or made for the purpose of financing permanent improvements to real estate. For FDIC-supervised institutions, Part 365 of the FDIC Rules and Regulations requires each institution to adopt and maintain written real estate lending policies that are consistent with sound lending principles, appropriate for the size of the institution and the nature and scope of its operations. Within these general parameters, the regulation specifically requires an institution to establish policies that include:

- *portfolio diversification standards;*
- *prudent underwriting standards including loan-to-value limits;*
- *loan administration procedures;*
- *documentation, approval and reporting requirements; and*
- *procedures for monitoring real estate markets within the institution's lending area.*

These policies also should reflect consideration of the "Interagency Guidelines for Real Estate Lending Policies" and must be reviewed and approved annually by the institution's board of directors.

The interagency guidelines, which are an appendix to Part 365, are intended to help institutions satisfy the regulatory requirements by outlining the general factors to consider when developing real estate lending standards. The guidelines suggest maximum supervisory loan-to-value (LTV) limits for various categories of real estate loans and explain how the agencies will monitor their use.

Institutions are expected to establish their own internal LTV limits consistent with their needs. These internal limits should not exceed the following recommended supervisory limits:

- *65 percent for raw land;*
- *75 percent for land development;*
- *80 percent for commercial, multi-family and other non-residential construction;*
- *85 percent for construction of a 1-to-4 family residence;*
- *85 percent for improved property; and*
- *Owner-occupied 1-to-4 family home loans have no suggested supervisory LTV limits. However, for any such loan with an LTV ratio that equals or exceeds 90 percent at origination, an institution should require appropriate credit enhancement in the form of either mortgage insurance or readily marketable collateral.*

Certain real estate loans are exempt from the supervisory LTV limits because of other factors that significantly reduce risk. These include loans guaranteed or insured by the federal, state or local government as well as loans to be sold promptly in the secondary market without recourse. A complete list of excluded transactions is included in the guidelines.

Because there are a number of credit factors besides LTV limits that influence credit quality, loans that meet the supervisory LTV limits should not automatically be considered sound, nor should loans that exceed the supervisory LTV limits automatically be considered high risk. However, loans that exceed the supervisory LTV limit should be identified in the institution's records and the aggregate amount of these loans reported to the institution's board of directors at least quarterly. The guidelines further state that the aggregate amount of loans in excess of the supervisory LTV limits should not exceed the institution's total capital. Moreover, within that aggregate limit, the total loans for all commercial, agricultural and multi-family residential properties (excluding 1-to-4 family home loans) should not exceed 30 percent of total capital.

Examination Procedures - *Institutions should develop policies that are clear, concise, consistent with sound real estate lending practices, and meet their needs. Policies should not be so complex that they place excessive paperwork burden on the institution. Therefore, when evaluating compliance with Part 365, examiners should carefully consider the following:*

- *the size and financial condition of the institution;*
- *the nature and scope of the institution's real estate lending activities;*
- *the quality of management and internal controls;*
- *the size and expertise of the lending and administrative staff; and*
- *market conditions.*

It is important to distinguish between the regulation and the interagency guidelines. While the guidelines *are included as an appendix to the regulation, they are not part of the regulation. Therefore, when an apparent violation of Part 365 is identified, it should be listed in the examination report in the same manner as other apparent violations. Conversely, when an examiner determines that an institution is not in conformance with the guidelines and the deficiency is a safety and soundness concern, an appropriate comment should be included in the examination report, however, the deficiency would not be a violation of the regulation.*

Commercial Real Estate Loans

These loans comprise a major portion of many banks' loan portfolios. When problems exist in the real estate markets that the bank is servicing, it is necessary for examiners to devote additional time to the review and evaluation of loans in these markets.

There are several warning signs that real estate markets or projects are experiencing problems that may result in real estate values decreasing from original appraisals or projections. Adverse economic developments and/or an overbuilt market can cause real estate projects and loans to become troubled. Signs of troubled real estate markets or projects include but are not limited to:

1. **Rent concessions or sales discounts resulting in cash flow below the level projected in the original appraisal.**
2. **Changes in concept or plan: for example, a condominium project converting to an apartment project.**
3. **Construction delays resulting in cost overruns which may require renegotiation of loan terms.**
4. **Slow leasing or lack of sustained sales activity and/or increasing cancellations which may result in protracted repayment or default.**
5. **Lack of any sound feasibility study or analysis.**
6. **Periodic construction draws which exceed the amount needed to cover construction costs and related overhead expenses.**
7. **Identified problem credits, past due and non-accrual loans.**

Real Estate Construction Loans

A construction loan is used to construct a particular project within a specified period of time and should be controlled by supervised disbursement of a predetermined sum of money. It is generally secured by a first mortgage or deed of trust and backed by a purchase or takeout agreement from a financially responsible permanent lender. Construction loans are vulnerable to a wide variety of risks. The major risk arises from the necessity to complete projects within specified cost and time limits. The risk inherent in construction lending can be limited by establishing policies that specify that type and extent of bank involvement. Such policies should define procedures for controlling disbursements and collateral margins and assuring timely completion of the projects and timely repayment of the bank's loans.

Before a construction loan agreement is entered into, the bank should investigate the character, expertise, and financial standing of all related parties. Documentation files should include background information concerning reputation, work and credit experience, and financial statements. Such documentation should indicate that the developer, contractor, and subcontractors have demonstrated the capacity to successfully complete the type of project to be undertaken. The appraisal techniques used to value a proposed construction project are essentially the same as those used for other types of real estate. The bank should realize that appraised collateral values are not usually met until funds are advanced and improvements made.

The bank, the builder and the property owner should join in a written building loan agreement that specifies the performance of each party during the entire course of construction. Loan funds are generally disbursed based upon either a standard payment plan or a progress payment plan. The standard payment plan is normally used for residential and smaller commercial construction loans and utilizes a preestablished schedule for fixed payments at the end of each specified stage of construction. The progress payment plan is normally used for larger, more complex, building projects. The plan is generally based upon monthly disbursements totaling 90% of the value with 10% held back until the project is

completed.

Although many credits advanced for real estate acquisition, development or construction are properly considered loans secured by real estate, other such credits are, in economic substance, "investments in real estate ventures" and categorization of the asset as "other real estate owned" may be appropriate. A key feature of these transactions is that the bank as lender plans to share in the expected residual profit from the ultimate sale or other use of the development. These profit sharing arrangements may take the form of equity kickers, unusually high interest rates, a percentage of the gross rents or net cash flow generated by the project, or some other form of profit participation over and above a reasonable amount for interest and related loan fees. These extensions of credit may also include such other characteristics as nonrecourse debt, 100% financing of the development cost (including origination fees, interest payments, construction costs, and even profit draws by the developer), and lack of any substantive financial support from the borrower or other guarantors. ADC arrangements that are in substance real estate investments of the bank should be reported accordingly.

On the other hand, if the bank will receive less than a majority of the expected residual profit, the ADC loan may be analogous to an interest in a joint real estate venture which would be considered an "investment in unconsolidated subsidiaries and associated companies."

The following are the basic types of construction lending:

1. Unsecured Front Money - Unsecured front money loans are working capital advances to a borrower who may be engaged in a new and unproven venture. Many bankers believe that unsecured front money lending is not prudent unless the bank is involved in the latter stages of construction financing. Front money loans are often used by a builder to start a project before construction funding is obtained. The funds may be used to acquire or develop a building site, eliminate title impediments, pay architect or standby fees, and/or meet minimum working capital requirements established by construction lenders. Repayment often comes from the first draw against construction financing. Unsecured front money loans used for a developer's equity investment in a project or to cover initial costs overruns are symptomatic of an undercapitalized, inexperienced or inept builder.

2. Land Development Loans - Land development loans are generally secured purchase or development loans or unsecured advances to investors and speculators. Secured purchase or development loans are usually a form of financing involving the purchase of land and lot development in anticipation of further construction or sale of the property. A land development loan should be predicated upon a proper title search and/or mortgage insurance. The amount of the loan should be based on appraisals on an "as is" and "as completed" basis. Projections should be accompanied by a study explaining the effect of property improvements on the market value of the land. There should be a sufficient spread between the amount of the development loan and the estimated market value to allow for unforeseen expenses. The repayment program should be structured to follow the sales or development program. In the case of an unsecured land development loan to investors or speculators, bank management should analyze the borrower's financial statements for sources of repayment other than the expected return on the property development.

3. Commercial Construction Loans - Loans financing commercial construction projects are usually collateralized, and such collateral is generally identical to that for commercial real estate loans. Supporting documentation should include a recorded mortgage or deed of trust, title insurance policy and/or title opinions, appropriate liability insurance and other coverages, land appraisals, and evidence that taxes have been paid to date. Additional documents relating to commercial construction loans include loan agreements, takeout commitments, tri-party (buy/sell) agreements, completion or corporate bonds, and inspection or progress reports.

4. Residential Construction Loans - Residential construction loans may be made on a

speculative basis or as prearranged permanent financing. Smaller banks often engage in this type of financing and the aggregate total of individual construction loans may equal a significant portion of their capital funds. Prudence dictates that permanent financing be assured in advance because the cost of such financing can have a substantial affect on sales. Proposals to finance speculative housing should be evaluated in accordance with predetermined policy standards compatible with the institution's size, technical competence of its management, and housing needs of its service area. The prospective borrower's reputation, experience, and financial condition should be reviewed. The finished project's marketability in favorable and unfavorable market conditions should be realistically considered. In addition to normal safeguards such as a recorded first mortgage, acceptable appraisal, construction agreement, draws based on progress payment plans and inspection reports, a bank dealing with speculative contractors should institute control procedures tailored to the individual circumstances. A predetermined limit on the number of unsold units to be financed at any one time should be included in the loan agreement to avoid overextending the contractor's capacity.

Loans on larger residential construction projects are usually negotiated with prearranged permanent financing. Documentation of tract loans frequently includes a master note allocated for the entire project and a master deed of trust or mortgage covering all land involved in the project. Payment of the loan will depend largely upon the sale of the finished homes. As each sale is completed, the bank makes a partial release of the property covered by its master collateral document. In addition to making periodic inspections during the course of construction, periodic progress reports (summary of inventory lists maintained for each tract project) should be made on the entire project. The inventory list should show each lot number, type of structure, release price, sales price, and loan balance.

The exposure in any type of construction lending is that full value of the collateral does not exist at the time the loan is granted. The bank must ensure funds are used properly to complete construction or development of the property serving as collateral. If default occurs, the bank must be in a position to either complete the project or to salvage its construction advances. The various mechanic's and materialmen's liens, tax liens, and other judgments that arise in such cases are distressing to even the most seasoned lender. Every precaution should be taken by the lender to minimize any outside attack on the collateral. The construction lender may not be in the preferred position indicated by documents in the file. Laws of some state favor the subcontractors (materialmen's liens, etc.), although those of other states protect the construction lender to the point of first default provided certain legal requirements have been met. Depending on the type and size of project being funded, construction lending can be a complex and fairly high-risk venture. For this reason, a bank's management should ensure that it has enacted policies and retained sufficiently trained personnel before engaging in this type of lending.

<u>Home Equity Loans</u>

A home equity loan is a loan secured by the equity in a borrower's residence. It is generally structured in one of two ways. First, it can be structured as a traditional second mortgage loan, wherein the borrower obtains the funds for the full amount of the loan immediately and repays the debt with a fixed repayment schedule. Second, the home equity borrowing can be structured as a line of credit, with a check, credit card, or other access to the line over its life.

The home equity line of credit has evolved into the dominant form of home equity lending. This credit instrument generally offers variable interest rates and flexible repayment terms. Additional characteristics of this product line include relatively low interest rates as compared to other forms of consumer credit, absorption by some banks of certain fees (origination, title search, appraisal, recordation cost, etc.) associated with establishing a real estate-related loan. The changes imposed by the Tax Reform Act of 1986 relating to the income tax deductibility of interest paid on consumer debt led to the increased popularity of home equity lines of credit.

Home equity lending is widely considered to be a low-risk lending activity. These loans are secured by housing assets, the value of which historically has performed well. Nevertheless, the possibility exists that local housing values or household purchasing power may decline, stimulating abandonment of the property and default on the debt secured by the housing. Certain features of home equity loans make them particularly susceptible to such risks. First, while the variable rate feature of the debt reduces the interest rate risk of the lender, the variable payment size exposes the borrower to greater cash flow risks than would a fixed-rate loan, everything else being equal. This, in turn, exposes the lender to greater credit risk. Another risk is introduced by the very nature of the home equity loan. Such loans are generally secured by a junior lien. Thus, there is less effective equity protection than in a first lien instrument. Consequently, a decline in the value of the underlying housing results in a much greater than proportional decline in the coverage of a home equity loan. This added leverage makes them correspondingly riskier than first mortgages.

Banks that make these kind of loans should adopt specific policies and procedures for dealing with this product line. Management should have expertise in both mortgage lending as well as open-end credit procedures. Another major concern is that borrowers will become overextended and the bank will have to initiate foreclosure proceedings. Therefore, underwriting standards should emphasize the borrower's ability to service the line from cash flow rather than the sale of the collateral, especially if the home equity line is written on a variable rate basis. If the bank has offered a low introductory interest rate, repayment capacity should be analyzed at the rate that could be in effect at the conclusion of the initial term.

Other important considerations include acceptable loan-to-value and debt-to-income ratios, and proper credit and collateral documentation, including adequate appraisals and written evidence of prior lien status. Another significant risk concerns the continued lien priority for subsequent advances under a home equity line of credit. State law governs the status of these subsequent advances. It is also important that the bank's program include periodic reviews of the borrower's financial condition and continuing ability to repay the indebtedness.

The variation in contract characteristics of home equity debt affects the liquidity of this form of lending. For debt to be easily pooled and sold in the secondary market, it needs to be fairly consistent in its credit and interest rate characteristics. The complexity of the collateral structures, coupled with the uncertain maturity of revolving credit, makes home equity loans considerably less liquid than straight first lien, fixed maturity mortgage loans.

Agricultural Lending

The purposes, terms and considerations regarding agricultural lending are quite similar to those already discussed in relation to Commercial Loans. Generally, agricultural advances will fall within three broad categories: seasonal (short-term) loans, intermediate, and long-term loans.

Seasonal loans are utilized for such purposes as the purchase of feeder livestock, feed, and expenses such as chemicals, fuels and labor associated with yearly crop production. Repayment is generally dependent on the successful production and sale of crops, or the profitable feeding and sale of livestock.

Longer term advances are utilized for such things as the purchase of machinery, breeding herds, dairy herds, feeding and/or confinement facilities, and in some cases, acquisition or improvement of real estate. As with any type of term loan, regular repayment is dependent on the additional cash flow expected to be generated as a result of these purchases. Two risks particularly evident in agricultural lending are the possibility of adverse weather conditions, and sizeable and uncontrollable fluctuations in commodity prices. To some extent, the purchase of crop insurance, some types of hedging and forward contracting, and producer participation in various types of government-sponsored programs may serve to lessen these two risk factors. However, these factors, coupled with general economic uncertainties, make it necessary for banks to ensure that agricultural loans are carefully tailored to an individual borrower's existing and projected repayment ability.

In this light, it is the regulators' policy not to discourage banks from forbearing on farm loans through appropriate debt restructurings, recognizing that such restructuring may be in the interests of both the bank and the borrower when there is a reasonable prospect that the borrower will eventually be able to repay the loan.

A bank's agricultural lending policies should address at least the following areas: acquisition of credit information such as property, operating and cash flow statements; factors that might determine the need for collateral acquisition; acceptable collateral margins; perfecting of liens on collateral; and lending terms.

Instalment Loans

A bank's instalment loan portfolio is usually comprised of a large number of small loans scheduled to be amortized over a specific period. Most instalment loans are made directly for consumer purchases, but business loans granted for the purchase of heavy equipment or industrial vehicles may also be included. In addition, the department may grant indirect loans for the purchase of consumer goods.

The examiner's emphasis in reviewing the instalment loan department should be on the overall procedures, policies and credit qualities. The goal should not be limited to identifying current portfolio problems, but should include potential future problems that may result from ineffective policies, unfavorable trends, potentially dangerous concentrations, or nonadherence to established policies. *At a minimum, a bank's direct instalment lending policies should address the following factors: loan applications and credit checks; terms in relation to collateral; collateral margins; perfection of liens; extensions, renewals and rewrites; delinquency notification and follow-up; and charge-offs and collections. For indirect lending, the policy additionally should address direct payment to the bank vs. payment to the dealer, acquisition of dealer financial information, possible upper limits for any one dealer's paper, other standards governing acceptance of dealer paper, and dealer reserves and charge-backs.*

Direct Lease Financing

Leasing is a recognized form of term debt financing for fixed assets. While leases differ from loans in some respects, they are similar from a credit viewpoint because the basic considerations are cash flow, repayment capacity, credit history, management and projections of future operations. Additional considerations for a lease transaction are the type of property and its marketability in the event of default or termination of the lease. Those latter considerations do not radically alter the manner in which an examiner evaluates collateral for a loan. The assumption is that the lessee/borrower will generate sufficient funds to liquidate the lease/debt. Sale of leased property/collateral remains a secondary source of repayment and, except for the estimated residual value at the expiration of the lease, will not, in most cases, become a factor in liquidating the advance. When the bank is requested to purchase property of significant value for lease, it may issue a commitment to lease, describing the property, indicating cost, and generally outlining the lease terms. After all terms in the lease transaction are resolved by negotiation between the bank and its customer, an order is usually written requesting the bank to purchase the property. Upon receipt of that order, the bank purchases the property requested and arranges for delivery and, if necessary, installation. A lease contract is drawn incorporating all the points covered in the commitment letter, as well as the rights of the bank and lessee in the event of default. The lease contract is generally signed simultaneously with the signing of the order to purchase and the agreement to lease.

The types of assets that may be leased are numerous, and the accounting for direct leasing is a complex subject which is discussed in detail in Financial Accounting Standards Board (FASB) Statement Number 13. Familiarity with FASB No. 13 is a prerequisite for the management of any bank engaging in or planning to engage in direct lease financing. The following terms are commonly encountered in direct lease financing: (1) Net Lease, one in which the bank is not directly or indirectly obligated to assume the expenses of maintaining the equipment. This restriction does not prohibit the bank from paying delivery and set up charges on the property. (2) Full Payout Lease, one for which the bank expects to realize both the return of its full investment and the cost of financing the property over the term of the lease. This payout can come from rentals, estimated tax benefits, and estimated residual value of the property. (3) Leveraged Lease, in

which the bank as lessor purchases and becomes the owner of equipment by providing a relatively small percentage (20-40%) of the capital needed. Balance of the funds is borrowed by the lessor from long-term lenders who hold a first lien on the equipment and assignments of the lease and lease rental payments. This specialized and complex form of leasing is prompted mainly by a desire on the part of the lessor to shelter income from taxation. Creditworthiness of the lessee is paramount and the general rule is a bank should not enter into a leveraged lease transaction with any party to whom it would not normally extend unsecured credit. (4) Rentals, which includes only those payments reasonably anticipated by the bank at the time the lease is executed.

Bank management should carefully evaluate all lease variables, including the estimate of the residual value. Banks may be able to realize unwarranted lease income in the early years of a contract by manipulating the lease variables. In addition, a bank can offer the lessee a lower payment by assuming an artificially high residual value during the initial structuring of the lease. But this technique may present the bank with serious long-term problems because of the reliance on speculative or nonexistent residual values.

Often, lease contracts contain an option permitting the lessee to continue use of the property at the end of the original term, working capital restrictions and other restrictions or requirements similar to debt agreements, and lease termination penalties. Each lease is an individual contract written to fulfill the lessee's needs. Consequently, there may be many variations of each of the above provisions. However, the underlying factors remain the same: there is a definite contractual understanding of the positive right to use the property for a specific period of time, and required payments are irrevocable.

In addition to areas discussed previously in connection with Commercial Loans, policy considerations relative to direct lease financing should address the various factors to be included in lease contracts.

Floor Plan Loans

Floor plan (wholesale) lending is a form of retail goods inventory financing in which each loan advance is made against a specific piece of collateral. As each piece of collateral is sold by the dealer, the loan advance against that piece of collateral is repaid. Items commonly subject to floor plan debt are automobiles, home appliances, furniture, television and stereophonic equipment, boats, mobile homes and other types of merchandise usually sold under a sales finance contract. Drafting agreements are a relatively common approach utilized in conjunction with floor plan financing. Under this arrangement, the bank establishes a line of credit for the borrower and authorizes the manufacturer of the goods to draw drafts on the bank in payment for goods shipped. The bank agrees to honor these drafts, assuming proper documentation (such as invoices, manufacturer's statement of origin, etc.) is provided. The method facilitates inventory purchases by, in effect, guaranteeing payment to the manufacturer for merchandise supplied. Floor plan loans involve all the basic risks inherent in any form of inventory financing. However, because of the banker's inability to exercise full control over the floored items, the exposure to loss may be greater than in other similar types of financing. Most dealers have minimal capital bases relative to debt. As a result, close and frequent review of the dealer's financial information is necessary. As with all inventory financing, collateral value is of prime importance. Control requires the bank to determine the collateral value at the time the loan is placed on the books, frequently inspect the collateral to determine its condition, and impose a curtailment requirement sufficient to keep collateral value in line with loan balances.

Handling procedures for floor plan lines will vary greatly depending on bank size and location, dealer size and the type of merchandise being financed. In many cases, the term "trust receipt" is used to describe the debt instrument existing between the bank and the dealer. Trust receipts may result from drafting agreements between a bank and a manufacturer for the benefit of a dealer. In other instances, the dealer may order inventory, bring titles or invoices to the bank, and then obtain a loan secured or to be secured by the inventory. Some banks may use master debt instruments, and others may use a trust receipt or note for each piece of inventory. The method of perfecting a security interest also varies from state to state. The important point is that a bank enact realistic handling policies and ensure that its collateral position is properly protected.

A bank's floor plan lending policy should at least address assessing the financial responsibility of the individual dealer, establishing curtailment programs, perfecting liens on collateral, and floor plan inspections.

Check Credit and Credit Card Loans

Check credit is defined as the granting of unsecured revolving lines of credit to individuals or businesses. Check credit services are provided by the overdraft system, cash reserve system, and special draft system. The most common is the overdraft system. In that method, a transfer is made from a preestablished line of credit to a customer's demand deposit account when a check which would cause an overdraft position is presented. Transfers normally are made in stated increments, up to the maximum line of credit approved by the bank, and the customer is notified that the funds have been transferred. In a cash reserve system, customers must request that the bank transfer funds from their preestablished line of credit to their demand deposit account before negotiating a check against them. A special draft system involves the customer negotiating a special check drawn directly against a preestablished line of credit. In that method, demand deposit accounts are not affected. In all three systems, the bank periodically provides its check credit customers with a statement of account activity. Required minimum payments are computed as a fraction of the balance of the account on the cycle date and may be made by automatic charges to a demand deposit account.

Most bank credit card plans are similar. The bank solicits retail merchants, service organizations and others who agree to accept a credit card in lieu of cash for sales or services rendered. The parties also agree to a discount percentage of each sales draft and a maximum dollar amount per transaction. Amounts exceeding that limit require prior approval by the bank. Merchants also may be assessed a fee for imprinters or promotional materials. The merchant deposits the bank credit card sales draft at the bank and receives immediate credit for the discounted amount. The bank assumes the credit risk and charges the nonrecourse sales draft to the individual customer's credit card account. Monthly statements are rendered by the bank to the customer who may elect to remit the entire amount, generally without service charge, or pay in monthly installments, with an additional percentage charged on the outstanding balance each month. A cardholder also may obtain cash advances from the bank or dispensing machines. Those advances accrue interest from the transaction date.

A bank may be involved in a credit card plan in three ways. (1) Agent Bank which receives credit card applications from customers and sales drafts from merchants and forwards such documents to banks described below, and is accountable for such documents during the process of receiving and forwarding. (2) Sublicensee Bank which maintains accountability for credit card loans and merchant's accounts; may maintain its own center for processing payments and drafts; and may maintain facilities for embossing credit cards. (3) Licensee Bank which is the same as sublicensee bank, but in addition may perform transaction processing and credit card embossing services for sublicensee banks, and also acts as a regional or national clearinghouse for sublicensee banks.

A bank's policies in the areas of check credit and credit card loans should address procedures for careful screening of account applicants; establishment of internal controls to prevent interception of cards before delivery or merchants from obtaining control of cards or customers from making fraudulent use of lost or stolen cards; frequent review of delinquent accounts, accounts where payments are made by drawing on reserves, and accounts with steady usage; delinquency notification procedures; guidelines for realistic charge-offs; removal of accounts from delinquent status (curing) through performance not requiring a catchup of delinquent principal; and provisions which preclude automatic reissuance of expired cards to obligors with charged-off balances or an otherwise unsatisfactory credit history with the bank.

Credit Card-related Merchant Activities

Merchant credit card activities basically involve the acceptance of credit card sales drafts for clearing by a financial institution (the "Clearing Institution"). For the Clearing Institution, these activities are generally characterized by thin profit margins amidst high transactional and sales volumes. Typically, a *merchant's customer will charge an item on a credit card, and the Clearing Institution will give credit to the merchant's account. Should the customer dispute a charge transaction, the Clearing Institution is obligated to honor the customer's legitimate request to reverse the transaction. The Clearing Institution must then seek reimbursement from the merchant. Problems arise when the merchant is not creditworthy and is unable, or unwilling, to reimburse the Clearing Institution. In these instances, the Clearing Institution will incur a loss. Examiners should review for the existence of any such contingent liabilities. Any potential losses should be treated according to the instructions in the Contingent Liabilities Section of this Manual.*

In order to avoid losses and to ensure the safe and profitable operation of a Clearing Institution's credit card activities, the merchants with whom it contracts for clearing services should be financially sound and honestly operated. To this end, safe and sound merchant credit card activities should include clear and detailed acceptance standards for merchants. These standards include the following:

1. *A Clearing Institution should scrutinize prospective merchants with the same care and diligence that it uses in evaluating prospective borrowers.*
2. *Financial institutions engaging in credit card clearing operations must closely monitor their merchants. Controls should be in place to ensure that early warning signs are recognized so that problem merchants can be removed from a Clearing Institution's program promptly to minimize loss exposure.*
3. *In cases of merchants clearing large dollar volumes, a Clearing Institution should establish an account administration program that, at a minimum, incorporates periodic reviews of the merchants' financial statements and business activities.*
4. *A Clearing Institution should establish an internal periodic reporting system of merchant account activities regardless of the amount or number of transactions cleared, and these reports should be reviewed for irregularities so that the Clearing Institution alerts itself quickly to problematic merchant activity. and*
5. *Clearing Institutions should follow the guidelines that are established by the card issuing networks.*

Another possible problem with merchant activities involves Clearing Institutions that sometimes engage the services of agents, such as an independent sales organization ("ISO"). ISOs solicit merchants' credit card transactions for a Clearing Institution. In some cases, the ISOs actually contract with merchants on behalf of Clearing Institutions. Some of these contracts are entered into by the ISOs without the review and approval of the Clearing Institutions. At times, Clearing institutions unfortunately rely too much on the ISOs to oversee account activity. In some cases, Clearing Institutions have permitted ISOs to contract with disreputable merchants. Because of the poor condition of the merchant, or ISO, or both, these Clearing Institutions can ultimately incur heavy losses.

A financial institution with credit card clearing activities should develop its own internal controls and procedures to ensure sound agent selection standards before engaging an ISO. ISOs that seek to be compensated solely on the basis of the volume of signed-up merchants should be carefully scrutinized. A Clearing Institution should adequately supervise the ISO's activities just as the institution should supervise any third party engaged to perform services for any aspect of the institution's operations. Also, it should reserve the right to ratify or reject any merchant contract that is initiated by an ISO.

III. OTHER CREDIT ISSUES

Appraisals

Appraisals are professional judgments of the market value of real property. Three basic valuation approaches are used by professional appraisers in estimating the market value of real property the cost approach, the market data or direct sales comparison approach, and the income approach. The principles governing the three approaches are widely known in the appraisal field and are referenced in parallel regulations issued by each of the federal bank and thrift regulatory agencies. When evaluating collateral, the three valuation approaches are not equally appropriate.

1. **Cost Approach - In the cost approach, the appraiser estimates the reproduction cost of the building and improvements, deducts estimated depreciation, and adds the value**

of the land. The cost approach is particularly helpful when reviewing draws on construction loans. However, as the property increases in age, both reproduction cost and depreciation become more difficult to estimate. Except for special purpose facilities, the cost approach is usually inappropriate in a troubled real estate market because construction costs for a new facility normally exceed the market value of existing comparable properties.

2. Market Data or Direct Sales Comparison Approach - This approach examines the price of similar properties that have sold recently in the local market, estimating the value of the subject property based on the comparable properties' selling prices. It is very important that the characteristics of the observed transactions be similar in terms of market location, financing terms, property condition and use, timing, and transaction costs. The market approach generally is used in valuing owner-occupied residential property because comparable sales data are typically available. When adequate sales data are available, an analyst generally will give the most weight to this type of estimate. Often, however, the available sales data for commercial properties are not sufficient to justify a conclusion.

3. The Income Approach - The economic value of an income-producing property is the discounted value of the future net operating income stream, including any "reversion" value of property when sold. If competitive markets are working perfectly, the observed sales price should be equal to this value. For unique properties or in depressed markets, value based on a comparable sales approach may be either unavailable or distorted. In such cases, the income approach is usually the appropriate method for valuing the property.

   The income approach converts all expected future net operating income into present value terms. When market conditions are stable and no unusual patterns of future rents and occupancy rates are expected, the direct capitalization method is often used to estimate the present value of future income streams. For troubled properties, however, the more explicit discounted cash flow (net present value) method is more typically utilized for analytical purposes. In the rent method, a time frame for achieving a "stabilized", or normal, occupancy and rent level is projected. Each year's net operating income during that period is discounted to arrive at present value of expected future cash flows. The property's anticipated sales value at the end of the period until stabilization (its terminal or reversion value) is then estimated. The reversion value represents the capitalization of all future income streams of the property after the projected occupancy level is achieved. The terminal or reversion value is then discounted to its present value and added to the discounted income stream to arrive at the total present market value of the property.

<u>Valuation of Troubled Income-Producing Properties</u>

When an income property is experiencing financial difficulties due to general market conditions or due to its own characteristics, data on comparable property sales often are difficult to obtain. Troubled properties may be hard to market, and normal financing arrangements may not be available. Moreover, forced and liquidation sales can dominate market activity. When the use of comparables is not feasible (which is often the case for commercial properties), the net present value of the most reasonable expectation of the property's income-producing capacity - not just in today's market but over time - offers the most appropriate method of valuation in the supervisory process.

Estimates of the property's value should be based upon reasonable and supportable projections of the determinants of future net operating income: rents (or sales), expenses and rates of occupancy. Judgment is involved in estimating all of these factors. The primary considerations for these projections include historical levels and trends, the current market performance achieved by the subject and similar properties, and economically feasible and defensible projections of future demand and supply conditions. To the extent that current market activity is dominated by a limited number of transactions or liquidation sales, high capitalization and discount rates implied by such transactions should not be used. Rather, analysts should use rates that reflect market conditions that are neither highly speculative nor depressed.

Appraisal Regulation

Title XI of the Federal Financial Institutions Reform, Recovery, and Enforcement Act of 1989 requires that appraisals prepared by certified or licensed appraisers be obtained in support of real estate lending and mandates that the Federal financial institutions regulatory agencies adopt regulations regarding the preparation and use of appraisals in certain real estate related transactions by financial institutions under their jurisdiction. In addition, Title XI created the Appraisal Subcommittee (Subcommittee) of the Federal Financial Institutions Examination Council (FFIEC) to provide oversight of the real estate appraisal process as it relates to federally related real estate transactions. The Subcommittee is composed of six members, each of whom is designated by the head of their respective agencies. Each of the five financial institution regulatory agencies which comprise the FFIEC and the U.S. Department of Housing and Urban Development are represented on Subcommittee. A responsibility of the Subcommittee is to monitor the State certification and licensing of appraisers. It has the authority to disapprove a state appraiser regulatory program, thereby disqualifying the state's licensed and certified appraisers from conducting appraisals for federally related transactions. The Subcommittee gets its funding by charging state certified and licensed appraisers an annual registration fee. The fee income is used to cover Subcommittee administrative expenses and to provide grants to the Appraisal Foundation.

Formed in 1987, the Appraisal Foundation was established as a private notforprofit corporation bringing together interested parties within the appraisal industry, as well as users of appraiser services, to promote professional standards within the appraisal industry. The Foundation sponsors two independent boards referred to in Title XI, The Appraiser Qualifications Board (AQB) and The Appraisal Standards Board (ASB). Title XI specifies that the minimum standards for State appraiser certification are to be the criteria for certification issued by the AQB. Title XI does not set specific criteria for the licensed classification. These are individually determined by each State. Additionally, Title XI requires that the appraisal standards prescribed by the federal Agencies, at a minimum, must be the appraisal standards promulgated by the ASB. The ASB has issued The Uniform Standards of Professional Appraisal Practice (USPAP) which set the appraisal industry standards for conducting an appraisal of real estate. To the appraisal industry, USPAP is analogous to generally accepted accounting principles for the accounting profession.

In conformance with Title XI, Part 323 of the FDIC regulations identifies which real estate related transactions require an appraisal by a certified or licensed appraiser and establishes minimum standards for performing appraisals. Substantially similar regulations have been adopted by each of the federal financial institutions regulatory agencies.

Real estate-related transactions include real estate loans, mortgage-backed securities, bank premises, real estate investments, and other real estate owned. All real estate-related transactions by FDIC-insured institutions not specifically exempt are, by definition, "federally related transactions" subject to the requirements of the regulation. Exempt real estate-related transactions include: (1) transactions valued at $100,000 or less; (2) liens on real property taken as an abundance of caution, i.e. loan terms were not made more favorable because of the lien; (3) leases that are not the economic equivalent of a purchase or sale; (4) renewals of performing loans provided no significant new funding beyond the original amount is advanced and the property value has not obviously and materially deteriorated; and (5) purchased pooled loans or mortgage-backed securities where appropriate appraisals were performed at origination.

While real estate loans of $100,000 and less and certain other transactions are exempt from the regulation, the FDIC Guidelines for Real Estate Appraisal Policies and Review Procedures apply to all real estate loans of any amount. The guidelines urge an institution to obtain an adequate evaluation of real estate collateral by a competent person (who need not be a certified or licensed appraiser) before entering into any real estate-related financial transaction.

Section 323.4 establishes minimum standards for all appraisals in connection with federally related transactions. All appraisals performed in conformance with the regulation must conform to the requirements of the USPAP and certain other listed standards. The applicable sections of

USPAP are the Preamble (ethics and competency), Standard 1 (appraisal techniques), Standard 2 (report content), and Standard 3 (review procedures). USPAP Standards 4 through 10 concerning appraisal services and appraising personal property do not apply to federally related transactions. The regulation does not allow the use of USPAP's Departure Provision for federally related transactions. The Departure Provision enables appraisers to perform an assignment that calls for something less than or different from the work that would otherwise be required by USPAP.

An appraisal satisfies the regulation if it is performed in accordance with all of its provisions and it is still current and meaningful. In other words, a new appraisal does not necessarily have to be done every time there is a transaction, provided the institution has an acceptable process in place to review existing appraisals.

Adherence to the appraisal regulation and appraisal guidelines should be part of the examiner's overall review of the lending function. An institution's written appraisal program should contain specific administrative review procedures that provide some evidence, such as a staff member's signature on an appraisal checklist, that indicates the appraisal was reviewed and that all standards were met. In addition, the regulation requires that the appraisal contain the appraiser's certification that it was prepared in conformance with USPAP. When analyzing individual transactions, examiners should review appraisal reports to determine the institution's conformity to its own internal appraisal policies and for compliance with the regulation. Examiners may need to conduct a more detailed review if the appraisal does not have sufficient information, does not explain assumptions, is not logical, or has other major deficiencies that cast doubt as to the validity of its opinion of value.

Loans in a pool such as an investment in mortgage- backed securities or collateralized mortgage obligations should have some documented assurance that each loan in the pool has an appraisal in accordance with the regulation. Appropriate evidence could include an issuer's certification of compliance.

All violations of Part 323 should be listed in the examination report in the usual manner. Significant systemic failures to meet standards and procedures could call for formal corrective measures.

Interagency Appraisal and Evaluation Guidelines

These guidelines (which were last issued on October 27, 1994) address supervisory matters relating to real estate-related financial transactions and provide guidance to examining personnel and federally regulated institutions about prudent appraisal and evaluation policies, procedures, practices, and standards.

Supervisory Policy - *An institution's real estate appraisal and evaluation policies and procedures will be reviewed as part of the examination of the institution's overall real estate-related activities. An institution's policies and procedures should be incorporated into an effective appraisal and evaluation program. Examiners will consider the institution's size and the nature of its real estate-related activities when assessing the appropriateness of its program.*

When analyzing individual transactions, examiners will review an appraisal or evaluation to determine whether the methods, assumptions, and findings are reasonable and in compliance with the agencies' appraisal regulations, policies, supervisory guidelines, and the institution's policies. Examiners also will review the steps taken by an institution to ensure that the individuals who perform its appraisals and evaluations are qualified and are not subject to conflicts of interest. Institutions that fail to maintain a sound appraisal or evaluation program or to comply with the agencies' appraisal regulations, policies, or these supervisory guidelines will be cited in examination reports and may be criticized for unsafe and unsound banking practices. Deficiencies will require corrective action.

Appraisal and Evaluation Program - *An institution's board of directors is responsible for reviewing and adopting policies and procedures that establish an effective real estate appraisal and evaluation program. The program should:*

- *Establish selection criteria and procedures to evaluate and monitor the ongoing performance of individuals who perform appraisals or evaluations;*
- *Provide for the independence of the person performing appraisals or evaluations;*
- *Identify the appropriate appraisal for various*

lending transactions;

- *Establish criteria for contents of an evaluation;*
- *Provide for the receipt of the appraisal or evaluation report in a timely manner to facilitate the underwriting decision;*
- *Assess the validity of existing appraisals or evaluations to support subsequent transactions;*
- *Establish criteria for obtaining appraisals or evaluations for transactions that are otherwise exempt from the agencies' appraisal regulations; and*
- *Establish internal controls that promote compliance with these program standards.*

Selection of Individuals Who May Perform Appraisals and Evaluations - *An institution's program should establish criteria to select, evaluate, and monitor the performance of the individual(s) who performs a real estate appraisal or evaluation. The criteria should ensure that:*

- *The institution's selection process is non-preferential and unbiased;*
- *The individual selected possesses the requisite education, expertise and competence to complete the assignment;*
- *The individual selected is capable of rendering an unbiased opinion; and*
- *The individual selected is independent and has no direct or indirect interest, financial or otherwise, in the property or the transaction.*

Under the agencies' appraisal regulations, the appraiser must be selected and engaged directly by the institution or its agent. The appraiser's client is the institution, not the borrower. An institution may use an appraisal that was prepared by an appraiser engaged directly by another financial services institution, as long as the institution determines that the appraisal conforms to the agencies' appraisal regulations and is otherwise acceptable.

Independence of the Appraisal And Evaluation Function - *Because the appraisal and evaluation process is an integral component of the credit underwriting process, it should be isolated from influence by the institution's loan production process. An appraiser and an individual providing evaluation services should be independent of the loan and collection functions of the institution and have no interest, financial or otherwise, in the property or the transaction. If absolute lines of independence cannot be achieved, an institution must be able to clearly demonstrate that it has prudent safeguards to isolate its collateral evaluation process from influence or interference from the loan production process.*

The agencies recognize, however, that it is not always possible or practical to separate the loan and collection functions from the appraisal or evaluation process. In some cases, such as in a small or rural institution or branch, the only individual qualified to analyze the real estate collateral may also be a loan officer, other officer, or director of the institution. To ensure their independence, such lending officials, officers, or directors should abstain from any vote or approval involving loans on which they performed an appraisal or evaluation.

Transactions That Require Appraisals - *Although the agencies' appraisal regulations exempt certain categories of real estate-related financial transactions from the appraisal requirements, most real estate transactions over $250,000 are considered federally related transactions and thus require appraisals. A "federally related transaction" means any real estate-related financial transaction in which the agencies engage, contract for, or regulate, and that requires the services of an appraiser. An agency also may impose more stringent appraisal requirements than the appraisal regulations require, such as when an institution's troubled condition is attributable to real estate loan underwriting problems.*

Minimum Appraisal Standards - *The agencies' appraisal regulations include five minimum standards for the preparation of an appraisal. The appraisal must:*

- *Conform to generally accepted appraisal standards as evidenced by the Uniform Standards of Professional Appraisal Practice (USPAP) promulgated by the Appraisal Standards Board (ASB) of the Appraisal Foundation unless principles of safe and sound banking require compliance with stricter standards;*

Although allowed by USPAP, the agencies' appraisal regulations do not permit an appraiser to appraise any *property in which the appraiser has an interest, direct or indirect, financial or otherwise.*

- *Be written and contain sufficient information and analysis to support the institution's decision to engage in the transaction;*

As discussed below, appraisers have available various appraisal development and report options; however, not all options may be appropriate for all transactions. A report option is acceptable under the agencies' appraisal regulations only if the appraisal report contains sufficient information and analysis to support an institution's decision to engage in the transaction.

- *Analyze and report appropriate deductions and discounts for proposed construction or renovation, partially leased buildings, non-market lease terms, and tract developments with unsold units;*

This standard is designed to avoid having appraisals prepared using unrealistic assumptions and inappropriate methods. For federally related transactions, an appraisal is to include the current market value of the property in its actual physical condition and subject to the zoning in effect as of the date of the appraisal. For properties where improvements are to be constructed or rehabilitated, the regulated institution may also request a prospective market value based on stabilized occupancy or a value based on the sum of retail sales. However, the sum of retail sales for a proposed development is not the market value of the development for the purpose of the agencies' appraisal regulations. For proposed developments that involve the sale of individual houses, units, or lots, the appraiser must analyze and report appropriate deductions and discounts for holding costs, marketing costs and entrepreneurial profit. For proposed and rehabilitated rental developments, the appraiser must make appropriate deductions and discounts for items such as leasing commission, rent losses, and tenant improvements from an estimate based on stabilized occupancy.

- *Be based upon the definition of market value set forth in the regulation; and*

Each appraisal must contain an estimate of market value, as defined by the agencies' appraisal regulations.

- *Be performed by State-licensed or certified appraisers in accordance with requirements set forth in the regulation.*

Appraisal Options - *An appraiser typically uses three market value approaches to analyze the value of a property -- cost, income, and comparable sales -- and reconciles the results of each to estimate market value. An appraisal will discuss the property's recent sales history and contain an opinion as to the highest and best use of the property. An appraiser must certify that he/she has complied with USPAP and is independent. Also, the appraiser must disclose whether the subject property was inspected and whether anyone provided significant assistance to the person signing the appraisal report.*

An institution may engage an appraiser to perform either a Complete or Limited Appraisal. When performing a Complete Appraisal assignment, an appraiser must comply with all USPAP standards without departing from any binding requirements and specific guidelines when estimating market value. When performing a Limited Appraisal, the appraiser elects to invoke the Departure Provision which allows the appraiser to depart, under limited conditions, from standards identified as specific guidelines. For example, in a Limited Appraisal, the appraiser might not utilize all three approaches to value; however, departure from standards designated as binding requirements is not permitted. There are numerous binding requirements which are detailed in the USPAP. Use of the USPAP Standards publication as a reference is recommended. The book provides details on each appraisal standard and advisory opinions issued by the Appraisal Standards Board.

An institution and appraiser must concur that use of the Departure Provision is appropriate for the transaction before the appraiser commences the appraisal assignment. The appraiser must ensure that the resulting appraisal report will not mislead the institution or other intended users of the appraisal report. The agencies do not prohibit the use of a Limited Appraisal for a federally related transaction, but the agencies believe that institutions should be cautious in their use of a Limited Appraisal because it will be less thorough than a Complete Appraisal.

Complete and Limited Appraisal assignments may be reported in three different report formats: a Self-Contained Report, a Summary Report, or a Restricted Report. The major difference among these three reports relates to the degree of detail presented in the report by the appraiser. The Self-Contained Appraisal Report provides the most detail, while the Summary Appraisal Report presents the information in a *condensed manner. The Restricted Report provides a capsulized report with the supporting details maintained in the appraiser's files.*

The agencies believe that the Restricted Report format will not be appropriate to underwrite a significant number of federally related transactions due to the lack of sufficient supporting information and analysis in the appraisal report. However, it might be appropriate to use this type of appraisal report for ongoing collateral monitoring of an institution's real estate transactions and under other circumstances when an institution's program requires an evaluation.

Moreover, since the institution is responsible for selecting the appropriate appraisal report to support its underwriting decisions, its program should identify the type of appraisal report that will be appropriate for various lending transactions. The institution's program should consider the risk, size, and complexity of the individual loan and the supporting collateral when determining the level of appraisal development and the type of report format that will be ordered. When ordering an appraisal report, institutions may want to consider the benefits of a written engagement letter that outlines the institution's expectations and delineates each party's responsibilities, especially for large, complex, or out-of-area properties.

Transactions That Require Evaluations - *A formal opinion of market value prepared by a State licensed or certified appraiser is not always necessary. Instead, less formal evaluations of the real estate may suffice for transactions that are exempt from the agencies' appraisal requirements. The agencies' appraisal regulations allow an institution to use an appropriate evaluation of the real estate rather than an appraisal when the transaction:*

- *Has a value of $250,000 or less;*
- *Is a business loan of $1,000,000 or less, and the transaction is not dependent on the sale of, or rental income derived from, real estate as the primary source of repayment; or*
- *Involves an existing extension of credit at the lending institution, provided that: (I) there has been no obvious and material change in the market conditions or physical aspects of the property that threaten the adequacy of the institution's real estate collateral protection after the transaction, even with the advancement of new monies; or (ii) there is no advancement of new monies other than funds necessary to cover reasonable closing costs.*

Institutions should also establish criteria for obtaining appraisals or evaluations for safety and soundness reasons for transactions that are otherwise exempt from the agencies' appraisal regulations.

Evaluation Content - *An institution should establish prudent standards for the preparation of evaluations. At a minimum, an evaluation should:*

- *Be written;*
- *Include the preparer's name, address, and signature, and the effective date of the evaluation;*
- *Describe the real estate collateral, its condition, its current and projected use;*
- *Describe the source(s) of information used in the analysis;*
- *Describe the analysis and supporting information, and;*
- *Provide an estimate of the real estate's market value, with any limiting conditions.*

An evaluation report should include calculations, supporting assumptions, and, if utilized, a discussion of comparable sales. Documentation should be sufficient to allow an institution to understand the analysis, assumptions, and conclusions. An institution's own real estate loan portfolio experience and value estimates prepared for recent loans on comparable properties might provide a basis for evaluations.

An evaluation should provide an estimate of value to assist the institution in assessing the soundness of the transaction. Prudent practices also require that as an institution engages in more complex real estate-related financial transactions, or as its overall exposure increases, a more detailed evaluation should be performed. For example, an evaluation for a home equity loan might be based primarily on information derived from a sales data services organization or current tax assessment information, while an evaluation for an income-producing real estate property should fully describe the current and expected use of the property and include an analysis of the property's rental income and expenses.

Qualifications of Individuals Who Perform Evaluations - *Individuals who prepare evaluations should have real estate-related training or experience and knowledge of the market relevant to the subject property. Based upon their experience and training, professionals from several fields may be qualified to prepare evaluations of certain types of real estate collateral. Examples include individuals with appraisal experience, real estate lenders, consultants or sales persons, agricultural extension agents, or foresters. Institutions should document the qualifications and experience level of individuals whom the institution deems acceptable to perform evaluations. An institution might also augment its in-house expertise and hire an outside party familiar with a certain market or a particular type of property. Although not required, an institution may use State licensed or certified appraisers to prepare evaluations. As such, Limited Appraisals reported in a Summary or Restricted format may be appropriate for evaluations of real estate-related financial transactions exempt from the agencies' appraisal requirements.*

Valid Appraisals and Evaluations - *The agencies allow an institution to use an existing appraisal or evaluation to support a subsequent transaction, if the institution documents that the existing estimate of value remains valid. Therefore, a prudent appraisal and evaluation program should include criteria to determine whether an existing appraisal or evaluation remains valid to support a subsequent transaction. Criteria for determining whether an existing appraisal or evaluation remains valid will vary depending upon the condition of the property and the marketplace, and the nature of any subsequent transaction. Factors that could cause changes to originally reported values include: the passage of time; the volatility of the local market; the availability of financing; the inventory of competing properties; improvements to, or lack of maintenance of, the subject property or competing surrounding properties; changes in zoning; or environmental contamination. The institution must document the information sources and analyses used to conclude that an existing appraisal or evaluation remains valid for subsequent transactions.*

Renewals, Refinancings, and Other Subsequent Transactions - *The agencies' appraisal regulations generally allow appropriate evaluations of real estate collateral in lieu of an appraisal for loan renewals and refinancings; however, in certain situations an appraisal is required. If new funds are advanced in excess of reasonable closing costs, an institution is expected to obtain a new appraisal for the renewal of an existing transaction when there is a material change in market conditions or in the physical aspects of the property that threatens the institution's real estate collateral protection.*

The decision to reappraise or reevaluate the real estate collateral should be guided by the exemption for renewals, refinancings, and other subsequent transactions. Loan workouts, debt restructurings, loan assumptions, and similar transactions involving the addition or substitution of borrowers may qualify for the exemption for renewals, refinancings, and other subsequent transactions. Use of this exemption depends on the condition and quality of the loan, the soundness of the underlying collateral and the validity of the existing appraisal or evaluation.

A reappraisal would not be required when an institution advances funds to protect its interest in a property, such as to repair damaged property, because these funds should be used to restore the damaged property to its original condition. If a loan workout involves modification of the terms and conditions of an existing credit, including acceptance of new or additional real estate collateral, which facilitates the orderly collection of the credit or reduces the institution's risk of loss, a reappraisal or reevaluation may be prudent, even if it is obtained after the modification occurs.

An institution may engage in a subsequent transaction based on documented equity from a valid appraisal or evaluation, if the planned future use of the property is consistent with the use identified in the appraisal or evaluation. If a property, however, has reportedly appreciated because of a planned change in use of the property, such as rezoning, an appraisal would be required for a federally related transaction, unless another exemption applied.

Program Compliance - *An institution's appraisal and evaluation program should establish effective internal controls that promote compliance with the program's standards. An individual familiar with the appropriate agency's appraisal regulation should ensure that the institution's appraisals and evaluations comply with the agencies' appraisal regulations, these guidelines, and the institution's program. Loan administration files should document this compliance review, although a detailed analysis or comprehensive analytical procedures are not required for every appraisal or evaluation. For some loans, the compliance review may be part of the loan officer's overall credit analysis and may take the form of either a narrative or a* *checklist. Corrective action should be undertaken for noted deficiencies by the individual who prepared the appraisal or evaluation.*

An institution's appraisal and evaluation program should also have comprehensive analytical procedures that focus on certain types of loans, such as large-dollar credits, loans secured by complex or specialized properties, non-residential real estate construction loans, or out-of-area real estate. These comprehensive analytical procedures should be designed to verify that the methods, assumptions, and conclusions are reasonable and appropriate for the transaction and the property. These procedures should provide for a more detailed review of selected appraisals and evaluations prior to the final credit decision. The individual(s) performing these reviews should have the appropriate training or experience, and be independent of the transaction.

Appraisers and persons performing evaluations should be responsible for any deficiencies in their reports. Deficient reports should be returned to them for correction. Unreliable appraisals or evaluations should be replaced prior to the final credit decision. Changes to an appraisal's estimate of value are permitted only as a result of a review conducted by an appropriately qualified State licensed or certified appraiser in accordance with Standard III of USPAP.

***Portfolio Monitoring -** The institution should also develop criteria for obtaining reappraisals or reevaluations as part of a program of prudent portfolio review and monitoring techniques -- even when additional financing is not being contemplated. Examples of such types of situations include large credit exposures and out-of-area loans.*

***Referrals -** Financial institutions are encouraged to make referrals directly to state appraiser regulatory authorities when a State licensed or certified appraiser violates USPAP, applicable state law, or engages in other unethical or unprofessional conduct. Examiners finding evidence of unethical or unprofessional conduct by appraisers will forward their findings and recommendations to their supervisory office for appropriate disposition and referral to the state, as necessary.*

***Examination Treatment** - All apparent violations of the appraisal regulation should be described in the schedule of violations of laws and regulations. Management's comments and any commitments for correcting the practices that led to the apparent violation should be included. Violations that are technical in nature and do not impact the value conclusion generally should not require a new appraisal. (These technical violations should not be relisted in subsequent examinations.) Since the point of an appraisal is to help make sound loan underwriting decisions, getting an appraisal on a loan already made, simply to fulfill the requirements of the appraisal regulation, would be of little benefit. However, an institution should be expected to obtain a new appraisal on a loan in violation of the appraisal regulation when there is a safety and soundness reason for such action. For example, construction loans and lines of credit need to have the value of the real estate reviewed frequently in order for the institution to properly manage the credit relationship. It might also be, that for supervisory purposes, a new appraisal might be needed to determine the proper classification for examination purposes of a collateral dependent loan.*

Loan Participations

A loan participation is a sharing or selling of ownership interests in a loan between two or more financial institutions. Normally, a lead bank originates the loan and sells ownership interests to one or more participating banks at the time the loan is closed. The lead bank (originating bank) normally retains a partial interest in the loan, holds all loan documentation in its own name, services the loan, and deals directly with the customer for the benefit of all participants. Properly structured, loan participations allow selling banks to accommodate large loan requests which would otherwise exceed lending limits, diversify risk, and improve liquidity or obtain additional lendable funds. Participating banks are able to compensate for low local loan demand or invest in large loans without servicing burdens and origination costs. If not appropriately structured and documented, a participation loan can present unwarranted risks to both the seller and purchaser of the loan. Examiners should determine the nature and adequacy of the participation arrangement as well as analyze the credit quality of the loan.

Recourse Arrangements and Reporting Requirements - All recourse arrangements should be documented in writing. If a loan is sold with recourse back to the seller, the selling bank has, in effect, retained the full credit risk of the loan

and its lending limit to the borrower is not reduced by the amount sold to participants. Participation loans sold with recourse are to be treated as borrowings of the selling bank from the purchasing bank. Examiners should consider participations subject to formal or informal repurchase agreements (or understandings) to be participations "with recourse" regardless of other wording in the participation agreement to the contrary. The lead bank may retain, at its exclusive option, the right to repurchase a participating bank's interest in a loan and still preserve the "without recourse" character of the participation. In such cases, the agreement should clearly state that the lead bank is under no obligation to repurchase any participated interest.

In determining the true recourse nature of a participation, examiners must determine the extent to which the credit risk has been transferred from the lead bank to the participant. In general, if the risk of loss or obligation for payments of principal or interest is retained by, or may ultimately fall back upon, the seller or lead bank, the transaction must be reported by the seller as a borrowing from the purchaser and by the purchaser as a loan to the seller. Complete details on treatment of participation loans for reporting purposes are found in the Glossary for Call Report Instructions under the caption "Sales of Assets."

Independent Credit Analysis - A bank purchasing a participation loan is expected to perform the same degree of independent credit analysis of the loan as if it were the originator. To determine if a participation loan meets its credit standards, a participating bank must obtain all relevant credit information and details on collateral values, lien status, loan agreements and participation agreements before a commitment is made to purchase. The absence of such information is evidence that the participating bank has not been prudent in its credit decision.

During the life of the participation, the participant should monitor the servicing and the status of the loan. In order to exercise control of its ownership interest, a purchasing bank must ascertain that the selling bank will provide complete and timely credit information on a continuing basis.

The procedures for purchasing loan participations should be provided for in the bank's formal lending policy. The criteria for participation loans should be consistent with that for similar direct loans. The policy would normally require the complete analysis of the credit quality of obligations to be purchased, determination of value and lien status of collateral, and the maintenance of full credit information for the life of the participation.

Participation Agreements - A participation loan can present unique problems if the borrower defaults, the lead bank becomes insolvent, or a party to the participation arrangement does not perform as expected. These contingencies should be considered in a written participation agreement. The agreement should clearly state the limitations the originating and participating banks impose on each other and the rights all parties retain. In addition to the general terms of the participation transaction, participation agreements should specifically include the following considerations:

1. The obligation of the lead bank to furnish timely credit information and to provide notification of material changes in the borrower's status;

2. Requirements that the lead bank consult with participants prior to modifying any loan, guaranty, or security agreements and before taking any action on defaulted loans;

3. The specific rights and remedies available to the lead and participating banks upon default of the borrower;

4. Resolution procedures when the lead and participating banks cannot agree on the handling of a defaulted loan;

5. Resolution of any potential conflicts between the lead bank and participants in the event that more than one loan to the borrower defaults; and

6. Provisions for terminating the agency relationship between the lead and participating banks upon such events as insolvency, breach of duty, negligence, or misappropriation by one of the parties.

In some loan participation arrangements, the participation agreement provides for the allocation of loan payments on some basis other than in proportion to ownership interest; e.g., principal payments may be applied first to the participant's ownership interest and all remaining payments to the lead bank's ownership interest. In these instances, the participation agreement must also specify that in case of loan default, participants will share in all subsequent payments and collections in proportion to their respective ownership interests at the time of default. Without such a provision, the banks would not have a pro rata sharing of credit risk and participations thus sold would have to be considered as borrowings for examination and reporting purposes.

Participations Between Affiliated Institutions - Examiners should ascertain that banks do not relax their credit standards when dealing with affiliated institutions and that participation loans between affiliated institutions are in compliance with Section 23A of the Federal Reserve Act. The Federal Reserve Board Staff has interpreted that the purchase of a participation loan from an affiliate is exempt from Section 23A provided that (1) the bank's commitment to purchase is obtained by the affiliate before the loan is consummated by the affiliate, and (2) the bank's decision to participate is based upon the bank's independent evaluation of the creditworthiness of the loan. If these criteria are not strictly met, the loan participation could be subject to the qualitative and/or quantitative restrictions of Section 23A. Refer to the Related Organizations Section of this Manual which describes transactions with affiliates.

Environmental Risk Program

A lending institution should have in place appropriate safeguards and controls to limit exposure to potential environmental liability associated with real property held as collateral. The FDIC has issued "Guidelines for an Environmental Risk Program" to FDIC-supervised institutions which urges those institutions to establish environmental risk programs tailored to the level of risk in their lending and investment activities. These guidelines are as follows:

Guidelines for an Environmental Risk Program

The potential adverse effect of environmental contamination on the value of real property and the potential for liability under various environmental laws have become important factors in evaluating real estate transactions and making loans secured by real estate. Environmental contamination, and liability associated with environmental contamination, may have a significant adverse effect on the value of real estate collateral, which may in certain circumstances cause an insured institution to abandon its right to the collateral. It is also possible for an institution to be held directly liable for the environmental cleanup of real property collateral acquired by the institution. The cost of such a cleanup may exceed by many times the amount of the loan made to the borrower. A loan may be affected adversely by potential environmental liability even where real property is not taken as collateral. For example, a borrower's capacity to make payments on a loan may be threatened by environmental liability to the borrower for the cost of a hazardous contamination cleanup on property unrelated to the loan with the institution. The potential for environmental liability may arise from a variety of federal and state environmental laws and from common law tort liability.

Environmental Risk Program

As part of the institution's overall decision-making process, the environmental risk program should establish procedures for identifying and evaluating potential environmental concerns associated with lending practices and other actions relating to real property. The board of directors should review and approve the program and designate a senior officer knowledgeable in environmental matters responsible for program implementation. The environmental risk program should be tailored to the needs of the lending institution. That is, institutions that have a heavier concentration of loans to higher risk industries or localities of known contamination may require a more elaborate and sophisticated environmental risk program than institutions that lend more to lower risk industries or localities. The environmental risk program should provide for staff training, set environmental policy guidelines and procedures, require an environmental review or analysis during the application process, include loan documentation standards, and establish appropriate environmental risk assessment safeguards in loan workout situations and foreclosures.

Examination Procedures

Examiners should review an institution's environmental risk program as part of the examination of its lending and investment activities. When analyzing individual credits, examiners should review the institution's compliance with its own environmental risk program. Failure to establish or comply with an appropriate environmental program should be criticized and corrective action required.

IV. LOAN PROBLEMS

It would be impossible to enumerate all sources and causes of problem loans. They cover a multitude of mistakes a bank may permit a borrower to make, as well as mistakes directly attributable to weaknesses in the bank's credit administration and management. Some well-constructed loans may develop problems due to unforeseen circumstances on the part of the borrower, however, bank management must endeavor to protect a loan by every means possible. One or more of the items in the following list is often basic to the development of loan problems.

Many of these items may also be indicative of potential bank fraud and/or insider abuse. Additional information on the warning signs and suggested areas for investigation are included in the Bank Fraud and Insider Abuse Section of this Manual.

Poor Selection Of Risks

Problems in this area may reflect the absence of sound lending policies, and/or management's lack of sound credit judgment in advancing certain loans. The following are general types of loans which may fall within the category of poor risk selection. It should be kept in mind that these examples are generalizations, and the examiner must weigh all relevant factors in determining whether a given loan is indeed a poor risk.

1. Loans to finance new and untried business ventures which are inadequately capitalized.
2. Loans based more upon the expectation of successfully completing a business transaction than on sound worth or collateral.
3. Loans for the speculative purchase of securities or goods.
4. Collateral loans made without adequate margin of security.
5. Loans made because of other benefits, such as the control of large deposit balances and not based upon sound worth or collateral.
6. Loans made without adequate owner equity in underlying real estate security.
7. Loans predicated on collateral which has questionable liquidation value.
8. Loans predicated on the unmarketable stock of a local corporation when the bank is at the same time lending directly to the corporation. Action which may be beneficial to the bank from the standpoint of the one loan may be detrimental from the standpoint of the other loan.
9. Loans which appear to be adequately protected by collateral or sound worth, but which involve a borrower of poor character risk and credit reputation.
10. Loans which appear to be adequately protected by collateral, but which involve a borrower with limited or unassessed repayment ability.
11. An abnormal amount of loans involving out-of-territory borrowers (excluding large banks properly staffed to handle such loans).
12. Loans involving brokered deposits or link financing.

Overlending

It is almost as serious, from the standpoint of ultimate losses, to lend a sound financial risk too much money as it is to lend to an unsound risk. Loans beyond the reasonable capacity of the borrower to repay invariably lead to the development of problem loans.

Failure to Establish or Enforce Liquidation Agreements

Loans granted without a well-defined repayment program violate a fundamental principle of sound lending. Regardless of what appears to be adequate collateral protection, failure to establish at inception or thereafter enforce a program of repayment almost invariably leads to troublesome and awkward servicing problems, and in many instances is responsible for serious loan problems including eventual losses. This axiom of sound lending is important not only from the lender's standpoint, but also the borrower's.

Incomplete Credit Information

Lending errors frequently result because of management's failure to obtain and properly evaluate credit information. Adequate and comparative financial statements, income statements, cash flow statements and other pertinent statistical support should be available. Other essential information, such as the purpose of the borrowing and intended plan or sources of repayment, progress reports, inspections, memoranda of outside information and loan conferences, correspondence, etc., should be contained in the bank's credit files. Failure of a bank's management to give proper attention to credit files makes sound credit judgment difficult if not impossible.

Overemphasis on Income

Misplaced emphasis upon loan income, rather than soundness, almost always leads to the granting of loans possessing undue risk. In the long run, unsound loans usually are far more expensive than the amount of revenue they may initially produce.

Self-Dealing

Pronounced self-dealing practices are almost always present in serious problem bank situations and in banks which fail. Such practices with regard to loans are found in the form of overextensions of credit on an unsound basis to insiders, or their interests, who have improperly used their positions to obtain unjustified loans. Active officers, who serve at the pleasure of the ownership interests, are often subjected to pressures which make it difficult to objectively evaluate such loans. Loans made for the benefit of ownership interests which may be actually carried in the name of a seemingly unrelated party are sometimes used to conceal self-dealing loans.

Technical Incompetence

Technical incompetence usually is manifested in management's inability to obtain and evaluate credit information and put together a well-conceived loan package. Management weaknesses in this area are almost certain to lead to eventual loan losses. Problems can also develop when management, technically sound in some forms of lending, becomes involved in specialized types of credit in which it lacks expertise and experience.

Lack of Supervision

Loan problems encountered in this area normally arise for one of two reasons: (1) Absence of effective active management supervision of loans which possessed reasonable soundness at inception. Ineffective supervision almost invariably results from lack of knowledge of a borrower's affairs over the life of the loan. It may well be coupled with one or more of the causes and sources of loan problems previously mentioned. (2) Failure of the board and/or senior management to properly oversee subordinates to determine that sound policies are being carried out.

Lack of Attention to Changing Economic Conditions

Economic conditions, both national and local, are continuously changing, and a bank's management must be responsive to these changes. This is not to suggest that a bank's lending policies should be in a constant state of flux, nor does it suggest that management should be able to forecast totally the results of economic changes. It does mean, however, that bankers should realistically evaluate lending policies and individual loans in light of changing conditions. Economic downturns can adversely affect borrowers' repayment potential and can lessen a bank's collateral protection. Reliance on previously existing conditions as well as optimistic hopes for economic improvement can, particularly when coupled with one or more of the causes and sources of loan problems previously mentioned, lead to serious loan portfolio deterioration.

Competition

Competition among financial institutions for growth, profitability, and community influence sometimes results in the compromise of sound credit principles and acquisition of unsound loans. The ultimate cost of unsound loans outweighs temporary gains in growth, income and influence.

Potential Problem Indicators by Document

The preceding discussions describe various practices or conditions which may serve as a source or cause of weak loans. Weak loans resulting from these practices or conditions may manifest themselves in a variety of ways. While it is impossible to provide a complete detailing of potential "trouble indicators", the following list, by document, may aid the examiner in identifying potential problem loans during the appraisal process.

1. Debt Instrument - Delinquency; irregular payments or payments not in accordance with terms; unusual or frequently modified terms; numerous renewals with little or no principal reduction; renewals that include interest; and extremely high interest rate in relation to comparable loans granted by the bank or the going rate for such loans in the bank's market area.

2. Liability Ledger - Depending on the type of debt, failure to amortize in a regular fashion over a reasonable period of time, e.g., on an annual basis, seasonally, etc.; and large number of out-of-territory borrowers, particularly in cases where these types of loans have increased substantially since the previous examination.

3. Financial and Operating Statements - Inadequate or declining working capital position; excessive volume or negative trend in receivables; unfavorable level or negative trend in inventory; no recent aging of receivables, or a marked slowing in receivables; drastic increase in volume of payables; repeated and increasing renewals of carry-over operating debt; unfavorable trends in sales and profits; rapidly expanding expenses; heavy debt-to-worth level and/or deterioration in this relationship; large dividend or other payments without adequate or reasonable earnings retention; and net worth enhancements resulting solely from reappraisal in the value of fixed assets.

4. Cash Flow Documentation - Absence of cash flow statements or projections, particularly as related to newly established term borrowers; projections indicating an inability to meet required interest and principal payments; and statements reflecting that cash flow is being provided by the sale of fixed assets or nonrecurring situations.

5. Correspondence and Credit Files - Missing and/or inadequate collateral or loan documentation, such as financial statements, security agreements, guarantees, assignments, hypothecation agreements, mortgages, appraisals, legal opinions and title insurance, property insurance, loan applications; evidence of borrower credit checks; corporate or partnership borrowing authorizations; letters indicating that a borrower has suffered financial reverses or has been unable to meet established repayment programs; and documents that reveal other unfavorable factors relative to a line of credit.

6. Collateral - Collateral evidencing a speculative loan purpose or collateral with inferior marketability characteristics (single purpose real estate, restricted stock, etc.) which has not been compensated for by other reliable repayment sources; and collateral of questionable value acquired subsequent to the extension of the credit.

V. LOAN APPRAISAL AND CLASSIFICATION

Loan Appraisal

In order to properly analyze any credit, an examiner must acquire certain fundamental information about a borrower's financial condition, purpose and terms of the borrowing, and prospects for its orderly repayment. The process involved in acquiring the foregoing information will necessarily vary with the size of the bank under examination and the type and sophistication of records utilized by the bank.

Because of the sheer volume of loans, it is necessary to focus attention on the soundness of larger lines of credit. Relatively smaller loans that appear to be performing satisfactorily may ordinarily be omitted from individual appraisal. The minimum size of the loan to be appraised depends upon the characteristics of the individual bank. The cut-off point should be low enough to permit an accurate appraisal of the loan portfolio as a whole, yet not so high as to preclude a thorough analysis of a representative portion of total loans. This procedure does not prevent an examiner from analyzing smaller loans which are steady for long periods of time, overdue, deficient in collateral coverage, or otherwise possess characteristics which would cause them to be subject to further scrutiny. In most instances, there should be direct correlation between the cut-off point utilized, the percentage of loans lined, and the asset quality and management ratings assigned at the previous examination.

The following loans or lines of credit should be analyzed at each examination:

1. Loans or lines of credit listed for Special Mention or adversely classified at the previous FDIC examination (State examination, if applicable as a result of an alternating examination program);

2. Loans reflected on the bank's problem loan list, if such a list exists;

3. Significant overdue loans as determined from the bank's overdue list, if such a list exists, or as determined by the examiner;

4. Other significant loans which exhibit a high degree of risk that have come to the examiner's attention in the review of minutes, audit reports or other sources;

5. Loans to the bank's insiders, and their related interests and insiders of other banks.

The degree of analysis and/or time devoted to the above loans may vary. For example, the time devoted to a previously classified loan which has been substantially reduced or otherwise improved may be significantly less than other loans. The reworking of certain loan files, such as seasoned real estate mortgages which are not subject to significant change, should be kept to a minimum or omitted. This does not mean that an examiner should not briefly review new file information (since the previous examination) to determine any adverse trends with respect to significant loans. In addition, the examiner should review a sufficient volume of different types of loans offered by the bank to determine that bank policies are adequate and being followed.

Review of Files and Records

Commercial loan liability ledgers or comparable subsidiary records vary greatly in quality and detail. Generally, they will provide the borrower's total commercial loan liability to the bank, and the postings thereto will depict a history of the debt. Collateral records should be scrutinized to acquire the necessary descriptive information and to ascertain that the collateral held to secure the notes is as transcribed.

Gathering credit information is an important process and should be done with care to obtain the essential information which will enable the examiner to appraise the loans accurately and fairly. Failure to obtain and record pertinent information contained in the credit files can reflect unfavorably on examiners, and a good deal of examiner and loan officer time can be saved by carefully analyzing the files. Ideally, credit files will also contain important correspondence between the bank and the borrower. However, this is not universally the case; in some instances, important correspondence is deliberately lodged in separate files because of its sensitive character. Correspondence between the bank and the borrower can be especially valuable to the examiner in developing added insight into the status of problem credits.

Verification of loan proceeds is one of the most valuable and effective loan examining techniques available to the examiner and often one of the most ignored. This verification process can disclose fraudulent or fictitious notes, misapplication of funds, loans made for the benefit or accommodation of parties other than the borrower of record, or utilization of loans for purposes other than those reflected in the bank's files. Verification of the disbursement of a selected group of large or unusual loans, particularly those subject to classification or special mention and those granted under circumstances which appear illogical or incongruous is important. However, it is more important to carry the verification process one step further to the apparent utilization of loan proceeds as reflected by the customer's deposit account or other related bank records. The examiner should also determine the purpose of the credit and the expected source of repayment.

Loan Discussion

The examiner must comprehensively review all data collected on the individual loans. In most banks, this review should allow the majority of loans to be passed without criticism, obviating the need for discussing these lines with the appropriate bank officer(s). No matter how thoroughly the bank's supporting loan files have been reviewed, there will invariably be a number of loans which will require additional information or discussion before an appropriate judgment can be made as to their credit quality, relationship to other loans, proper documentation, or other circumstances related to the overall examination of the loan portfolio. Such loans require discussion with the appropriate bank officer(s) as do other loans for which adequate information has been assembled to indicate that classification or special mention is warranted.

Proper preparation for the loan discussion is essential, and the following points should be given due consideration by the examiner. Loans which have been narrowed down for discussion should be reviewed in depth to insure a comprehensive grasp of all factual material. Careful advance preparation can save time for all concerned. Particularly with regard to large, complicated lines, undue reliance should not be placed on memory to cover important points in loan discussion. Important weaknesses and salient points to be covered in discussion, questions to be asked, and information to be sought should be noted. The loan discussion should not involve discussion of trivialities since the banker's time is valuable, and it is no place for antagonistic remarks and snide comments directed at loan officers. The examiner should listen carefully to what the banker has to say, and concisely and accurately note this information. Failure to do so can result in inaccuracies and make follow-up at the next examination more difficult.

Loan Analysis

In the appraisal of individual loans, the examiner should weigh carefully the information obtained and arrive at a judgment as to the credit quality of the loans under review. Each loan is appraised on the basis of its own characteristics. Consideration is given to the risk involved in the project being financed; the nature and degree of collateral security; the character, capacity, financial responsibility, and record of the borrower; and the feasibility and probability of its orderly liquidation in accordance with specified terms. The willingness and ability of a debtor to perform as agreed remains the primary measure of the risk of the loan. This implies that the borrower must have earnings or liquid assets sufficient to meet interest payments and provide for reduction or liquidation of principal as agreed at a reasonable and foreseeable date. However, it does not mean that borrowers must at all times be in a position to liquidate their loans, for that would defeat the original purpose of extending credit.

Following analysis of specific credits, it is important that the examiner ascertain whether troublesome loans result from inadequate lending and collection policies and practices or merely reflect exceptions to basically sound credit policies and practices. In instances where troublesome loans exist due to ineffective lending practices and/or inadequate supervision, it is quite possible that existing problems will go uncorrected and further loan quality deterioration may occur. Therefore, the examiner should not only identify problem loans, but also ascertain the cause(s) of these problems. Weaknesses in lending policies or practices should be stressed, along with possible corrective measures, in discussions with the bank's senior management and/or the directorate and in the Administration, Supervision, and Control and the Examination Conclusions and Comments schedules.

Loan Classification

To quantify and communicate the results of the loan appraisal, the examiner must arrive at a decision as to which loans are to be subjected to criticism and/or comment in the examination report. Adversely classified loans are allocated on the basis of risk to three categories:

1. Substandard;
2. Doubtful; and
3. Loss.

Other loans of questionable quality, but involving insufficient risk to warrant classification, are designated as Special Mention loans. Loans lacking technical or legal support, whether or not adversely classified, should be brought to the attention of the bank's management. If the deficiencies in documentation are severe in scope or volume, a schedule of such loans should be included in the report of examination.

Loan classifications are expressions of different degrees of a common factor, risk of nonpayment. All loans involve some risk, but the degree varies greatly. It is incumbent upon examiners to avoid classification of sound loans. The practice of lending to sound businesses or individuals for reasonable periods is a legitimate banking function. Adverse classifications should be confined to those loans which are unsafe for the investment of depositors' funds.

A revised statement on classification of bank assets and appraisal of securities in bank examinations was issued jointly on May 7, 1979, by the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Federal Reserve Board, and the Conference of State Bank Supervisors. This statement, a revision of an agreement issued in 1938 and revised July 15, 1949, clarifies definitions and eliminates practices duplicated elsewhere. It provides expanded definitions of "Substandard", "Doubtful", and "Loss" categories used for adversely classifying bank assets. Amounts classified "Loss" should be promptly eliminated from the bank's books.

Uniform guidelines have been established by the Division regarding the examination report treatment of assets classified "Doubtful". The general policy is not to require charge-off or similar action for Doubtful. Examiners should make a statement calling for a bank to charge-off a portion of loans classified Doubtful only when State law or policy requires. Further, any such statement should be clear as to its intended purpose of bringing the bank into conformity with those State requirements. An exception is made for formal actions under Section 8 of the FDI Act. A statement addressing the charge-off of loans classified Loss is a required comment on the Examination Conclusions and Comments schedule.

The above policy position concerning disposition of Doubtful assets also states that a careful assessment of the adequacy of the allowance for loan and lease losses (ALLL) be made. This assessment may begin with an evaluation of the bank's procedures, or absent these, examiners will need to develop their own approaches for making the analysis. Regardless of the method chosen, it is essential that provision be made for all risk of loss in the portfolio, both identified and unidentified. Loans classified in the examination report may be used to develop a measure for identifying problem loans, and, as a part of this process, the examiner may assign a 50% loss factor for loans classified Doubtful. After adjustments are made for Loss and one-half of the amount of Doubtful, peer averages may serve as a point of reference for the level of the allowance. Factors such as the volume and severity of adversely classified loans, management policies and capabilities, asset quality trends, portfolio strategies, charge-off and collection practices, and local and general economic conditions must be considered to support the examiner's determination as to the appropriate level for the ALLL. It is unlikely peer averages alone would be sufficient to determine what an adequate level should be. If, after the foregoing assessment, it is determined the level of the allowance is inadequate, recommendation for correction should be made on the Earnings and/or Capital Adequacy schedule in the report of examination and on the Examination Conclusions and Comments schedule if appropriate. This comment should emphasize the need for an adequate allowance and timely recognition of losses; it should also stress the propriety of paying cash dividends and the importance of the integrity of published financial data. The bank should be urged to correct any deficiency determined by the examiner by the next reporting period or within a reasonable time frame, although not later than the bank's fiscal year-end. In addition, the adequacy of the institution's methodology for determining the level of the ALLL should be assessed on the Administration, Supervision, and Control schedule. If the institution's methodology is deemed inadequate, appropriate comments should be included in the Examination Conclusions and Comments schedule.

Definitions

Substandard - Substandard loans are inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Loans so classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the bank will sustain some loss if the deficiencies are not corrected.

Doubtful - Loans classified Doubtful have all the weaknesses inherent in those classified Substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently known facts, conditions and values, highly questionable and improbable.

Loss - Loans classified Loss are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the loan has absolutely no recovery or salvage value but rather it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be effected in the future.

There is a close relationship between classifications, and no classification category should be viewed as more important than the other. The uncollectibility aspect of Doubtful and Loss classifications makes their segregation of obvious importance. The function of the Substandard classification is to indicate those loans which are unduly risky and may be a future hazard to the bank's solvency. No bank can safely hold a large amount of low quality loans, even though they are not presently subject to either a Doubtful or Loss classification.

A complete list of adversely classified loans is to be provided management, either during or at the close of an examination. This is especially true in those situations when total asset classifications amount to 25% or less of a bank's Tier 1 capital and the examination discloses no material problems or trends in the area of loan administration.

In these instances, the Assets Subject to Adverse Classification schedule may be deleted.

Special Mention Assets

Definition - A Special Mention asset has potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or in the institution's credit position at some future date. Special Mention assets are not adversely classified and do not expose an institution to sufficient risk to warrant adverse classification.

Use of Special Mention - The Special Mention category is not to be used as a means of avoiding a clear decision to classify a loan or pass it without criticism. Neither should it include loans listed merely "for the record" when uncertainties and complexities, perhaps coupled with large size, create some reservations about the loan. If weaknesses or evidence of imprudent handling cannot be identified, inclusion of such loans in Special Mention is not justified.

Ordinarily, Special Mention credits have characteristics which corrective management action would remedy. Often the bank's weak origination and/or servicing policies are the cause for the Special Mention designation. Examiners should not misconstrue the fact that most Special Mention loans contain management correctable deficiencies to mean that loans involving merely technical exceptions belong in this category. However, instances may be encountered where technical exceptions are a factor in scheduling loans for Special Mention.

Careful identification of loans which properly belong in this category is important in determining the extent of risk in the bank's loan portfolio and providing constructive criticism for bank management. While Special Mention Assets should not be combined with adversely classified assets in reports of examination, their total should be considered in the analysis of asset quality and management, as appropriate.

The nature of this category precludes inclusion of smaller lines of credit unless those loans are part of a large grouping listed for related reasons. Comments on loans listed for Special Mention in the Report of Examination should be drafted in a fashion similar to those for adversely classified loans. There is no less of a requirement upon the examiner to record clearly the reasons why the loan is listed. The major thrust of the comments should be in the direction of achieving correction of the deficiencies identified.

Troubled Commercial Real Estate Loan Classification Guidelines

Additional classification guidelines have been developed to aid the examiner in classifying troubled commercial real estate loans. These guidelines are intended to supplement the uniform guidelines discussed above. After performing an analysis of the project and its appraisal, the examiner must determine the classification of any exposure.

The following guidelines are to be applied in instances where the obligor is devoid of other reliable means of repayment, with support of the debt provided solely by the project. If other types of collateral or other sources of repayment exist, the project should be evaluated in light of these mitigating factors.

> Substandard - Any such troubled real estate loan or portion thereof should be classified Substandard when well-defined weaknesses are present which jeopardize the orderly liquidation of the debt. Well-defined weaknesses include a project's lack of marketability, inadequate cash flow or collateral support, failure to complete construction on time or the project's failure to fulfill economic expectations. They are characterized by the distinct possibility that the bank will sustain some loss if the deficiencies are not corrected.
>
> Doubtful - Doubtful classifications have all the weaknesses inherent in those classified Substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently known facts, conditions and values, highly questionable and improbable. A Doubtful classification may be appropriate in cases where significant risk exposures are perceived, but loss cannot be determined because of specific reasonable pending factors which may strengthen the credit in the near term. Examiners should attempt to identify loss in the credit where possible thereby limiting the excessive use of the Doubtful classification.
>
> Loss - Advances in excess of calculated current fair value which are considered uncollectible and do not warrant continuance as bankable assets. There is little or no prospect for near term improvement and no realistic strengthening action of significance pending.

Technical Exceptions

Deficiencies in documentation of loans should be brought to the attention of management for remedial action. Failure of management to effect corrections may lead to the development of greater credit risk in the future. Moreover, the presence of an excessive number of technical exceptions is a reflection on management's quality and ability. Inclusion of the schedule "Assets With Credit Data or Collateral Documentation Exceptions" and various comments in the report of examination is appropriate in certain circumstances. Refer to the Report of Examination Instructions for further guidance.

Past Due and Nonaccrual

Overdue loans are not necessarily subject to adverse criticism. Nevertheless, a high volume of overdue loans almost always indicates liberal credit standards, weak servicing practices, or both. Because loan renewal and extension policies vary among banks, comparison of their delinquency ratios may be misleading. A more significant method of evaluating this factor lies in determination of the trend within the bank under examination, keeping in mind the distortion resulting from seasonal influences, economic conditions, or the timing of examinations. It is important for the examiner to carefully consider the makeup and reasons for the volume of overdue loans. Only then can it be determined whether the volume of past due paper is a significant factor reflecting adversely on the quality or soundness of the overall loan portfolio or the efficiency and quality of management. It is important that overdue loans be computed on a uniform basis. This allows for comparison of overdue totals between examinations and/or with other banks.

The report of examination includes information on overdue and nonaccrual loans. Loans which are still accruing interest but are past their maturity or on which either interest or principal is due and unpaid (including unplanned overdrafts) are separated by loan type into two distinct

groupings: (1) 30 to 89 days past due; (2) 90 or more days past due. Nonaccrual loans may include both current and past due loans. In the case of installment credit, a loan will not be considered overdue until at least two monthly payments are delinquent. The same will apply to real estate mortgage loans, term loans or any other loans payable on regular monthly installments of principal and/or interest.

Some modification of the overdue criteria may be necessary because of applicable State law, joint examinations, or unusual circumstances surrounding certain kinds of loans or in individual loan situations. It will always be necessary for the examiner to ascertain the bank's renewal and extension policies and procedures for collecting interest prior to determining which loans are overdue, since such practices often vary considerably from bank to bank. This is important not only to validate which loans are actually overdue, but also to evaluate the soundness of such policies. Standards for renewal should be aimed at achieving an orderly liquidation of loans and not at maintaining a low ratio of past due paper through unwarranted extensions or renewals.

In larger departmentalized banks or banks with large branch systems, it may be informative to analyze delinquencies by determining the source of overdue loans by department or branch. This is particularly true if a large volume of overdue loans should exist. The production of schedules reflecting overdue loans by department or branch is encouraged if it will aid in pinpointing the source of a problem or be informative from the standpoint of supervision of the bank.

Continuing to accrue income on assets which are in default as to principal and interest overstates a bank's assets, earnings and capital. Instructions for the Preparation of Reports of Condition and Income indicate, in summary, that where the period of default of principal or interest equals or exceeds 90 days, the accruing of income should be discontinued unless the asset is well-secured and in process of collection. Banks are strongly recommended to follow this guideline not only for reporting purposes but also bookkeeping purposes. There are several exceptions, modifications and clarifications to this general standard. First, consumer loans and real estate loans secured by one-to-four family residential properties are exempt from the nonaccrual guidelines. Nonetheless, these exempt loans should be subject to other alternative methods of evaluation to assure the bank's net income is not materially overstated. Second, any State statute, regulation or rule which imposes more stringent standards for nonaccrual of interest should take precedence over these instructions. Third, reversal of previously accrued but uncollected interest applicable to any asset placed in a nonaccrual status, and treatment of subsequent payments as either principal or interest, should be handled in accordance with generally accepted accounting principles. Acceptable accounting treatment includes reversal of all previously accrued but uncollected interest against appropriate income and balance sheet accounts.

Finally, a debt is "well-secured" if collateralized by liens on or pledges of real or personal property, including securities, that have a realizable value sufficient to discharge the debt in full; or by the guarantee of a financially responsible party. A debt is "in process of collection" if collection is proceeding in due course either through legal action, including judgment enforcement procedures, or, in appropriate circumstances, through collection efforts not involving legal action which are reasonably expected to result in repayment of the debt or its restoration to a current status.

Nonaccrual Loans That Have Demonstrated Sustained Contractual Performance

The following guidance applies to borrowers who have resumed paying the full amount of scheduled contractual interest and principal payments on loans that are past due and in nonaccrual status. Although prior arrearage may not have been eliminated by payments from the borrowers, the borrower may have demonstrated sustained performance over a period of time in accordance with the contractual terms. Beginning in 1993, the regulators permitted such loans to be returned to accrual status, even though the loans have not been brought fully current, provided two criteria are met:

1. *all principal and interest amounts contractually due (including arrearage) are reasonably assured of repayment within a reasonable period, and*

2. *there is a sustained period of repayment performance (generally a minimum of six months) by the borrower, in accordance with the*

contractual terms involving payments of cash or cash equivalents.

When the regulatory reporting criteria for restoration to accrual status are met, previous charge-offs taken would not have to be fully recovered before such loans are returned to accrual status. Loans that meet the above criteria would continue to be disclosed as past due, as appropriate, until they have been brought fully current.

Troubled Debt Restructuring (TDR) Multiple Note Structure

The basic example of a TDR multiple note structure is a troubled loan that is restructured into two notes where the first or "A" note represents the portion of the original loan principal amount which is expected to be fully collected along with contractual interest. The second part of the restructured loan, or "B" note, represents the portion of the original loan that has been charged-off.

Such TDRs generally may take any of three forms. (1) In certain TDRs, the "B" note may be a contingent receivable that is payable only if certain conditions are met (e.g., sufficient cash flow from property). (2) For other TDRs, the "B" note may be contingently forgiven (e.g., note "B" is forgiven if note "A" is paid in full). (3) In other instances, an institution would have granted a concession (e.g., rate reduction) to the troubled borrower but the "B" note would remain a contractual obligation of the borrower. Because the "B" note is not reflected as an asset on the institution's books and is unlikely to be collected, for reporting purposes the "B" note could be viewed as a contingent receivable.

Institutions may return the "A" note to accrual status provided the following conditions are met:

1. *The restructuring qualifies as a TDR as defined by FASB Statement No.15 and there is economic substance to the restructuring.*

2. *The portion of the original loan represented by the "B" note has been charged off. The charge-off must be supported by a current, well-documented credit evaluation of the borrower's financial condition and prospects for repayment under the revised terms. The charge-off must be recorded before or at the time of the restructuring.*

3. *The "A" note is reasonably assured of repayment and of performance in accordance with the modified terms.*

4. *In general, the borrower must have demonstrated sustained repayment performance (either immediately before or after the restructuring) in accordance with the modified terms for a reasonable period prior to the date on which the "A" note is returned to accrual status. A sustained period of payment performance generally would be a minimum of six months and involve payments in the form of cash or cash equivalents.*

Under existing reporting requirements, the "A" note would be disclosed as a TDR. In accordance with these requirements, if the "A" note yields a market rate of interest and performs in accordance with the restructured terms, such disclosures could be eliminated in the year following restructuring. To be considered a market rate of interest, the interest rate on the "A" note at the time of restructuring must be equal to or greater than the rate that the institution is willing to accept for a new receivable with comparable risk.

Consumer Loan Analysis and Classification

Sound consumer credit is based upon the borrower's willingness and ability to pay as agreed. These ingredients are roughly measurable in terms of the borrower's character and the amount and stability of income in relation to current debt obligations. In turn, evidence of a consumer loan's soundness is probably best indicated by the repayment performance demonstrated by the borrower. These considerations, coupled with the fact that consumer loans are typically small in size and large in number, mandate that a different approach be utilized in appraising consumer credit than that which is generally followed with respect to other loan categories. In any case, large lines and direct and significant indirect dealer lines (not individual indirect paper) should receive individual appraisal.

The FDIC has adopted a policy for classifying delinquent consumer instalment loans held by commercial banks which utilizes a formula approach. This approach parallels, in principle, current industry practices and recognizes the statistical validity of measuring losses predicated on past-due status. The policy covers both open and closed-end credit. Evaluating the quality of a consumer credit portfolio on a loan-by-loan basis

is inefficient and unnecessary. For this reason, examiners are expected to adhere closely to the policy in analyzing consumer credit. Nevertheless, it is recognized that there are instances, particularly where significant amounts are involved, that may warrant exceptions to the formula in order to recognize individual situations where the bank being examined can clearly demonstrate that repayment will occur irrespective of delinquency status. Examples of such situations might include loans well-secured by collateral and in process of collection, loans where claims have been filed against solvent estates and loans supported by valid guarantees or insurance. Examiners will adhere to the following general classification policy during examinations of commercial banks. Closed-end consumer instalment credit delinquent 120 days or more (5 monthly payments) will be classified Loss and loans delinquent 90 to 119 days (4 monthly payments) will be classified Substandard. Open-end consumer instalment credit delinquent 180 days or more (7 zero billing cycles) will be classified Loss and loans delinquent 90 to 179 days (4 to 6 zero billing cycles) will be classified Substandard.

Under no circumstances should the formula approach be used for classification of large business type loans serviced by instalment loan departments. The following definitions are intended to provide guidance in application of the policy.

Consumer Instalment Loans: Include open and closed-end credit extended to individuals for household, family or other personal expenditures as defined in the Instructions for Preparation of Reports of Condition.

Delinquency: Closed-end instalment credit is considered delinquent when the borrower is in arrears two monthly payments. Open-end credit is generally treated differently in computing delinquency. A bank credit card customer generally has 25 days in which to pay billings before the loan is considered delinquent. If no payment is made between two billing cycles, the balance is considered 5 days delinquent. If no payment is received before issuance of still another statement, the balance is technically 35 days delinquent, however, current practice is to define accounts with two zero billings as 30 days delinquent.

Some banks consider a credit "cured" and no longer delinquent when a borrower resumes monthly payments, even if delinquent principal is not repaid. This practice is generally not objectionable provided the delinquency is not more than 90 days, resumed payments have occurred for a minimum of 3 consecutive months, another curing has not taken place within the preceding 12 months, and the loan balance does not exceed the predelinquency credit limit.

Partial Payments: A payment equivalent to 90% or more of the contractual payment may be considered a full payment in computing delinquency.

Use of the formula approach usually results in numerous items and, although not to be included in the report, an itemized list is to be left with management and the classified asset schedule should so indicate. A copy of the listing should also be retained in the examiner's work papers.

Examiners are reminded that examiner support packages are available which have built in parameters of the formula classification policy, and which generate a listing of delinquent consumer loans to be classified in accordance with the policy. Use of this package may expedite the examination in certain cases, especially in larger banks.

Losses are one of the costs of doing business in consumer instalment credit departments. It is important for the examiner to give consideration to the amount of instalment loan charge-offs and the character thereof in examining the department. Excessive loan losses are the product of weak lending and collection policies and therefore provide a good indication of the soundness of the consumer instalment loan operation. The examiner should be alert also to the absence of instalment loan charge-offs, which may indicate that losses are being deferred or covered up through unwarranted rewrites or extensions.

Dealer lines should be scheduled in the report under the dealer's name regardless of whether the contracts are accepted with or without recourse. Any classification or totaling of the nonrecourse line can be separately identified from the direct or indirect liability of the dealer. Comments and format for scheduling the indirect contracts will be essentially the same as for direct paper. If there is direct debt, comments will necessarily have to be more extensive and probably will help form a basis for the indirect classification.

No general rule can be established as to the proper application of dealers' reserves to the examiner's classifications. Such a rule would be impractical because of the many methods used by banks in setting up such reserves and the various dealer agreements utilized. Generally, where the bank is handling a dealer who is not financially responsible, weak contracts warrant classification irrespective of any balance in the dealer's reserve. Fair and reasonable judgment on the part of the examiner will determine application of dealer reserves.

If the amount involved would have a material impact on capital, consumer loans should be classified net of unearned income. Large business-type loans placed in consumer instalment loan departments should receive individual appraisal and, in all cases, the applicable unearned income discount should be deducted when such loans are classified.

Troubled Debt Restructurings, Foreclosures and Repossessions

Troubled debt restructuring takes place when a bank grants a concession to a debtor in financial difficulty. Statement of Financial Accounting Standards No. 15 (FASB 15), Accounting by Debtors and Creditors for Troubled Debt Restructurings, sets forth generally accepted accounting principles for restructurings. It is the FDIC's policy that restructurings be reflected in examination reports in accordance with FASB 15. In addition, banks are expected to follow these principles when filing Reports of Condition and Income.

FASB 15 divides troubled debt restructurings into two broad groups: (1) those wherein the borrower transfers assets to the creditor to satisfy the claim, which would include foreclosures; and (2) those in which the terms of a debtor's obligation are modified, which may include reduction in the interest rate, extension of the maturity date and at an interest rate that is less than the current market rate for new obligations with similar risk, or forgiveness of principal or interest. A third type of restructuring combines a receipt of assets and a modification of terms.

Transfer of Assets to the Creditor - Assets received by the bank from the debtor in full satisfaction of the book value of the bank's loan or security must be recorded at fair value. Any excess of the recorded investment in a loan over the fair value of the assets received is a loss to be charged to the allowance for loan and lease losses; any excess of the recorded investment in securities over the fair value should be classified as a securities loss.

To illustrate, assume a bank forecloses on a defaulted mortgage loan of $100,000 and takes title to the property. If the fair value of the realty at the time of foreclosure is $80,000, the $20,000 loss should be immediately recognized by a charge to the allowance for loan and lease losses. If the bank is on an accrual basis of accounting, there may also be adjusting entries necessary to reduce both the accrued interest receivable and loan interest income accounts. Assume further that in order to effect sale of the realty to a third party, the bank is willing to offer a new mortgage loan (e.g., of $100,000) at a concessionary rate of interest (e.g., 10% while the market rate for new loans with similar risk is 20%). Before booking this new transaction, the bank must establish its "economic value". Pursuant to Accounting Principles Board Opinion No. 21 (APBO 21, Interest on Receivables and Payables), the value is represented by the sum of the present value of the income stream to be received from the new loan, discounted at the current market rate for this type of credit, and the present value of the principal to be received, also discounted at the current market rate. This economic value is the proper carrying value for the asset at its origination date, and if less than the fair value at time of foreclosure (e.g., $78,000 vs. $80,000), an additional loss has been incurred and should be immediately recognized. This additional loss should be reflected in the allowance if a relatively brief period has elapsed between foreclosure and subsequent resale of the property. However, the loss should be treated as "other operating expenses" if the asset has been held for a longer period. The new loan would be placed on the books at its face value ($100,000) and the difference between the new loan amount and the "economic value" ($78,000) is treated as unearned discount ($22,000). For examination and Report of Condition purposes, the asset would be shown net of the unearned discount which is reduced periodically as it is earned over the life of the new loan. Interest income is earned on the restructured loan at the previously established market rate. This is computed by multiplying the carrying value (i.e., face amount of the loan reduced by any principal payments, less unearned discount) by that rate (20%).

The basis for this accounting approach is the assumption that financing the resale of the property at a concessionary rate exacts an opportunity cost which the bank must recognize. That is, unearned discount represents the present value of the "imputed" interest differential between the concessionary and market rates of interest. Present value accounting also assumes that both the bank and the third party who purchased the property are indifferent to a cash sales price at the "economic value" or a higher financed price repayable over time.

Modification of Terms - Whether modification of terms requires a change in the carrying value of the asset depends upon the total future cash receipts to be generated under the new terms. If the loan is restructured to the same borrower and the total amount of future payments under the modified terms is at least equal to the amount of principal outstanding plus any accrued and unpaid interest (plus or minus any unamortized premium or discount), FASB 15 requires no immediate recognition of loss, and present value computations under APBO 21 are not necessary. For example, in lieu of foreclosure, a bank may choose to add the accrued and unpaid interest to the loan balance and offer a new note in this amount to the borrower at a less-than-market rate. In this case, the total amount of future income and principal payments may be greater than the principal and accrued interest at the time of restructuring. The loss suffered by the bank is accounted for by the reduced income to be received over the life of the restructured debt.

If the terms are modified to the extent that total future cash receipts are less than the outstanding principal balance plus accrued and unpaid interest (plus or minus unamortized premium or discount), immediate loss recognition under FASB 15 is required. This situation might arise if the bank forgives a portion of principal or interest. The amount of loss is represented by the difference between the total future payments under the modified terms and the current balance of the present obligation. The initial balance at which the asset would be carried on the bank's books would be equal to these total future payments. Moreover, no interest income should be recognized over the life of this restructured asset, instead, all payments are to be applied to the loan or security balance.

Combination Approach - In some instances, the bank may receive assets in partial rather than full satisfaction of a loan or security and may also agree to alter the original repayment terms. In these cases, the recorded investment should be reduced by the fair value of the assets received and the remaining investment accounted for as a restructuring involving only modification of terms.

Examination Report Treatment - Examiners may encounter situations in which troubled debts have been restructured, but the bank has not properly accounted for the transactions. Where incorrect accounting treatment has resulted in an over statement of earnings, capital and assets, it will be necessary to determine the proper carrying values for the restructured assets, utilizing the best available information developed by the examiner after consultation with bank management. The unrecognized loss should be reflected in the examination report as a Loss classification, under the appropriate asset category.

Other Considerations - Notwithstanding the remarks immediately above, proper accounting for restructured debts is the responsibility of bank management. Examiners should not spend a disproportionate amount of time developing the appropriate accounting entries, but instead discuss with and request corrective action by bank management when the bank's treatment is not in accordance with accepted accounting guidelines. It must also be emphasized that collectability and proper accounting and reporting are separate matters; restructuring a borrower's debt does not ensure collection of the loan or security. Adverse classification of restructured obligations should be assigned if analysis indicates there is risk of loss present. Examiners should take care, however, not to discourage or be critical of bank management's legitimate and reasonable attempts to achieve debt settlements through concessionary terms. In many cases, restructurings offer the only realistic means for a bank to effect collection of weak or nonearning assets. Finally, the volume of restructured debts having concessionary interest rates should be considered when evaluating the bank's earnings performance and assigning the earnings performance rating.

Report of Examination Treatment of Classified Loans

The Items Subject to Adverse Classification schedule allows an examiner to present pertinent and readily understandable comments related to loans which are adversely classified. In addition, the Analysis of Loans Subject to Adverse Classification schedule permits analysis of present and previous classifications from the standpoint of source and disposition. These loan schedules should be prepared in accordance with the Report of Examination Instructions and current memoranda.
An examiner must present in written form pertinent and readily understandable comments related to loans which are subject to criticism. To accomplish this, a thorough understanding of all factors surrounding the loan is required and only those germane to its description, collectability and management plans should be included in the comments. Comments should be brief and concise, but brevity is not to be accomplished by omission of adequate and pertinent information. Comments should be informative and factual data emphasized. The important weaknesses of the loan should not be overshadowed by extraneous information which might well have been omitted. An ineffective presentation of a classified loan weakens the value of an examiner's report and frequently casts doubt on the accuracy of the classifications. The essential test of loan comments is whether they justify the classification.

Careful organization is an important ingredient of good loan comments. Generally, loan comments should consist of the following elements:

1. Identification - Indicate the name and occupation or type of business of the borrower. Cosigners, endorsers and guarantors should be identified and in the case of business loans, it should be clear whether the borrower is a corporation, partnership, or sole proprietorship.

2. Description - The make-up of the debt should be concisely described as to type of loan, amount, origin and terms. The history, purpose, and source of repayment should also be indicated.

3. Collateral - Describe and evaluate any collateral, indicating the marketability and/or condition thereof. If values are estimated, note the source.

4. Financial Data - Current balance sheet information along with operating figures should be presented, if such data are considered necessary. The examiner must exercise judgment as to whether a statement should be detailed in its entirety. When the statement is relevant to the classification, it is generally more effective to summarize weaknesses with the entire statement presented. On the other hand, if the statement does not significantly support or detract from the loan, a very brief summarization of the statement is in order.

5. Summarize the Problem - The examiner's comments should explicitly point out reasons for the classification. Where portions of the line are accorded different classifications or are not subject to classification, comments should clearly set forth the reasoning for the split treatment.

6. Management's Intentions - Comments should include any corrective program contemplated by management.

Examiners should avoid arbitrary or "penalty" classifications, nor should "conceded" or "agreed" be given as the principal reason for adverse classifications. Management's opinions and ideas should not have to be emphasized; if a classification is well-founded, the facts will speak for themselves. If well- written, there is little need for long summary comments reemphasizing major points of the loan write-up.

When the volume of loan classifications reaches the point of causing supervisory concern, analysis of present and previous classifications from the standpoint of source and disposition becomes very important. For this reason, the Analysis of Loans Subject to Adverse Classification schedule should be completed in the following cases: Banks which examiners regard as possessing characteristics which present special supervisory problems; When the volume or composition of adversely classified loans has changed significantly since the previous examination, including both upward and downward movements; and, in such other special or unusual situations as examiners deem appropriate. Generally, it is intended that the schedule not include consumer loans and

overdrafts and it should be footnoted to indicate that these assets are not included. This schedule can be a very useful tool in developing the Examiner's Comments and Conclusions schedule.

Allowance for Loan and Lease Losses

The adequacy of a bank's allowance for loan and lease losses continues to be one of the principal factors examiners must consider when evaluating the quality of a bank's earnings performance. Examiners should therefore ensure that bank management reviews the adequacy of its "allowance" on at least a quarterly basis. Furthermore, management must maintain reasonable records in support of their evaluations and entries.

In determining the adequacy of the "allowance for loan and lease losses," bank management cannot simply rely on maintaining the allowance at a certain percentage of total loans. In this respect, the use of such a benchmark (e.g., an allowance equal to 1% of total loans) does not ensure that an adequate valuation reserve has been set aside for anticipated and potential loan losses. Indeed, a specific bank may need to establish a higher balance for its allowance account if such is necessary to adequately offset the degree of risk inherent in the bank's loan portfolio.

Some of the factors that warrant consideration when determining the adequacy of the "allowance for loan and lease losses" include:

1. *The volume and mix of the existing loan portfolio, including the volume and severity of non-performing loans and adversely classified credits, as well as an analysis of net charge-offs experienced on previously classified loans;*

2. *The extent to which loan renewals and extensions are used to maintain loans on a current basis and the degree of risk associated with such loans;*

3. *The trend in loan growth, including any rapid increase in loan volume within a relatively short time period;*

4. *General and local economic conditions affecting the collectibility of the bank's loans;*

5. *Previous loan loss experience by loan type, including net charge-offs as a percent of average loans over the past several years;*

6. *The relationship and trend over the past several years of recoveries as a percent of previous year's charge-offs;*

7. *Available outside information of a comparable nature regarding the loan portfolios of other banks, including peer group banks.*

This list is not considered to be all-inclusive, but rather is an example of some of the considerations involved in determining the adequacy of the "allowance for loan and lease losses." During the evaluation of the adequacy of the valuation account, it is important for examiners and bank management to utilize a prospective (i.e., forward-looking) approach rather than just viewing loan loss potential from a historical viewpoint. For example, a bank's previous loan loss experience might tend to indicate that the bank's "allowance" account is being maintained at an adequate level. However, when the present level of nonperforming loans and the current condition of the bank's local economy are taken into consideration, the amount of the valuation account might actually be less than sufficient to offset the level of risk in the loan portfolio.

Examiner Evaluation of the Adequacy of the ALLL

Examiners should carefully review the documentation prepared by and methodologies used by management in determining its ALLL. The range of amounts over which an institution's general allowance would be considered adequate is typically determined by adding the various components of the allowance, including specific allocations or loss estimations for certain identified loans (i.e., those individually reviewed), specific allocations for pools of loans (not individually reviewed), and the supplemental portion for inherent loan portfolio losses. When the portfolio has been reviewed in these segments, individual loans should not be included in more than one grouping.

Management should justify the amounts or percentages of estimated losses applied to each of the segments (either individual loan or loan pool). Examiners should ensure that management is considering current and relevant data when evaluating loan collectibility as well as experience factors that are appropriate for the kinds of assets involved. If the institution has not had experience with a certain kind of asset over a sufficient time frame, consideration of the loss experience of its peers that have engaged in that type of lending may be appropriate.

Examiners should carefully review the specific *allocations that have been attributed to individual loans and pools of loans by management for purposes of determining the size of an adequate ALLL. In addition, when estimating the amount needed in the supplemental portion to cover the risk of error in estimating the probable loss inherent in loan amounts, it is appropriate to distinguish between those loans which have been individually reviewed (whether adversely classified or not) and those loans or pools of loans for which no specific review and estimations have been performed. Furthermore, an examiner should be aware of those loans on which amounts have already been charged off (or against which specific reserves have been established) when estimating the size of the supplemental portion. The risk of error in estimates of probable loss for collateralized and non-collateralized loans would normally differ and should be considered in the evaluation.*

Although examiners should review management's calculations and its ability to reasonably estimate loss, examiners must judge whether management has established general reserves in an amount that is adequate for the institution. First, the reserve must cover any losses on loans accorded Loss classifications (in whole or in part) which have not yet been charged off. After deducting the amounts classified Loss, examiners should ascertain whether the remainder of the ALLL is sufficient to cover the amounts they have estimated as probable losses for all loans accorded Doubtful classifications (but without partial Loss classification), those estimated probable losses for all remaining adversely classified loans (i.e., those without partial Loss or Doubtful classification) and other problem loans (either individually or in pools), and estimated probable losses for the remaining categories of loans in the portfolio plus a supplemental amount for unidentified loan portfolio losses.

Examiners are expected to use their professional judgement at all times in reaching conclusions regarding the overall condition of the institutions under examination based on the risks that are present and the exposure these risks may present to the insurance fund. Although examiners and management may reach differing conclusions for the amount of the ALLL, the methodology used by the FDIC is intended to have accounting consequences that fall within the range of acceptable accounting practice for banks and thrifts and not to create differences between regulatory accounting principles and GAAP.

Furthermore, examiners are encouraged, with the permission of the depository institution or at the institution's request, to communicate with the external auditors and request an explanation of their rationale and their findings when any differences in judgement concerning the adequacy of the institution's ALLL exist. In case of controversy, the auditors may be reminded of the consensus reached by the Financial Accounting Standards Board's Emerging Issues Task Force (EITF) on Issue No. 85-44, "Differences Between Loan Loss Allowances for GAAP and RAP." This issue deals with the situation where regulators "have mandated that institutions establish loan loss allowances under regulatory accounting principles (RAP) that may be in excess of amounts recorded by the institution in preparing its financial statement under" GAAP. The EITF was asked whether and under what circumstances this can occur. The consensus indicated that "auditors should be particularly skeptical in the case of GAAP/RAP differences and must justify them based on the particular facts and circumstances."

Accounting and Reporting Treatment

The current authoritative source of accounting guidance on the ALLL under GAAP is the Financial Accounting Standards Board's Statement No. 5, <u>Accounting for Contingencies</u> (FASB 5). FASB 5 states that an allowance for credit losses should be established when information prior to the issuance of the financial statements indicates that it is probable that a loss has occurred and the amount of that loss can be reasonably estimated. Under GAAP, no differences should exist in the criteria banks and thrifts use to determine when to establish reserves for inherent loan losses.

Because the size of the allowance is an estimate based upon a combination of facts and circumstances surrounding the individual institution and its loans, there may be disagreements in judgement over whether an inherent loss on a loan or pool of loans is "probable" and over the amount of loss that can be reasonably estimated. The determination of the amount needed in the allowance in order for it to be adequate does not result in a single acceptable number, but in a range of reasonable estimates. Thus, reasonable persons (i.e., management, auditors, and examiners), with differing experience, perspectives, and judgement may reasonably believe that different amounts constitute an adequate allowance. However, the estimates by each of these persons should fall within what is considered an acceptable range. When the allowance maintained by management is not within that range of acceptability, *examiners should seek appropriate adjustments by management.*

Examiners should refer to the Interagency Statement of Policy on the ALLL, dated December 1993. This policy statement provides comprehensive guidance on the maintenance of an adequate ALLL.

Issuance of "Express Determination" Letters to Banks for Federal Income Tax Purposes

Tax Rules - The Internal Revenue Code and tax regulations allow a deduction for a loan that becomes wholly or partially worthless. All pertinent evidence is taken into account in determining worthlessness. Special tax rules permit a federally supervised depository institution to elect a method of accounting under which it conforms its tax accounting for bad debts to its regulatory accounting for loan charge-offs, provided certain conditions are satisfied. Under these rules, loans that are charged off pursuant to specific orders of the institution's supervisory authority or that are classified by the institution as loss assets under applicable regulatory standards are conclusively presumed to have become worthless in the taxable year of the charge-offs. These special tax rules are effective for taxable years ending on or after December 31, 1991.

To be eligible for this accounting method for tax purposes, an institution must file a conformity election with its federal income tax return. The tax regulations also require the institution's primary federal supervisory authority to expressly determine that the institution maintains and applies loan loss classification standards that are consistent with the regulatory standards of its supervisory authority.

For taxable years ending before the completion of the first examination of an institution's loan review process that is after October 1, 1992, transition rules allow an institution to make the conformity election without the determination letter from its primary supervisory authority. However, the letter must be obtained at the first examination involving the loan review process after October 1, 1992. If the letter is not issued by the supervisory authority at the examination, the election is revoked retroactively.

Once the first examination of the loan review process after October 1, 1992, has been performed by an institution's primary federal supervisory authority, the transition rules no longer apply and the institution must have the "express determination" letter before making the election. To continue using the tax-book conformity method, the institution must request a new letter at each subsequent examination that covers the loan review process. If the examiner does not issue an "express determination" letter at the end of such an examination, the institution's election of the tax-book conformity method is revoked automatically as of the beginning of the taxable year that includes the date of examination. However, that examiner's decision not to issue an "express determination" letter does not invalidate an institution's election for any prior years. The supervisory authority is not required to rescind any previously issued "express determination" letters.

When an examiner does not issue an "express determination" letter, the institution is still allowed tax deductions for loans that are wholly or partially worthless. However, the burden of proof is placed on the institution to support its tax deductions for loan charge-offs.

Examination Procedures - Banks are responsible for requesting "express determination" letters during examinations that cover their loan review process, i.e., during safety and soundness examinations. Examiners should not alter the scope or frequency of examinations merely to permit banks to use the tax-book conformity method.

When requested by a bank that has made or intends to make the election under Section 1.166-2(d)(3) of the tax regulations, the examiner-in-charge should issue an "express determination" letter, provided the bank does maintain and apply loan loss classification standards that are consistent with the FDIC's regulatory standards. The letter should only be issued at the completion of a safety and soundness examination at which the examiner-in-charge has concluded that the issuance of the letter is appropriate.

Examiners should document in their workpapers their conclusions regarding the bank's loan loss classification standards and practices. FDIC standards for loan classifications and charge-offs are set forth on the preceding pages of this subsection.

An "express determination" letter should be issued to a bank only if:

1. The examination indicates that the bank maintains and applies loan loss classification standards that are consistent with the FDIC's standards regarding the identification and charge-off of such loans; and

2. There are no material deviations from the FDIC's standards.

Minor criticisms of the bank's loan review process as it relates to loan charge-offs or immaterial individual deviations from the FDIC's standards should not preclude the issuance of an "express determination" letter.

An "express determination" letter should not be issued if:

1. The bank's loan review process relating to charge-offs is subject to significant criticism;

2. Loan charge-offs reported in the Report of Condition and Income (Call Reports) are consistently overstated or understated; or

3. There is a pattern of loan charge-offs not being recognized in the appropriate year.

When the issuance of an "express determination" letter is appropriate, it should be prepared on FDIC letterhead using the following format. The letter should be signed and dated by the examiner-in-charge and provided to the bank for its files. The letter is not part of the report of examination.

Express Determination Letter for
IRS Regulation 1.166-2(d)(3)

In connection with the most recent examination of [Name of Bank], by the Federal Deposit Insurance Corporation, as of [Examination Date], we reviewed the institution's loan review process as it relates to loan charge-offs. Based on our review, we concluded that the bank, as of that date, maintained and applied loan loss classification standards that were consistent with regulatory standards regarding loan charge-offs.

This statement is made on the basis of a review that was conducted in accordance with our normal examination procedures and criteria, including sampling of loans in accordance with those procedures and criteria. It does not in any way limit or preclude any formal or informal supervisory action (including enforcement actions) by this supervisory authority relating to the institution's loan review process or the level at which it maintains its allowance for loan and lease losses.

[Signature]
Examiner-in-Charge

[Date Signed]

When an "express determination" letter is issued to a bank, a copy of the letter as well as documentation of the work performed by examiners in their review of the bank's loan loss classification standards should be maintained in the workpapers. A copy of the letter should also be forwarded to the Regional Office with the report of examination. A comment indicating that an "express determination" letter was provided to the bank should be included on page A of the report of examination.

When an examiner-in-charge concludes that the conditions for issuing a requested "express determination" letter have not been met, the examiner-in-charge should discuss the reasons for this conclusion with the Regional Office. The examiner-in-charge should then advise bank management that the letter cannot be issued and explain the basis for this conclusion. A comment indicating that a requested "express determination" letter could not be issued, together with a brief statement of the reasons for not issuing the letter should be included on page A of the report of examination.

VI. CONCENTRATIONS

Generally a concentration is a significantly large volume of economically-related assets that an institution has advanced or committed to one person, entity or affiliated group. These assets may in the aggregate present a substantial risk to the safety and soundness of the institution. Adequate diversification of risk allows the institution to avoid the excessive risks imposed by credit concentrations. It should also be recognized, however, that factors such as location and economic environment of the area limit some institutions' ability to diversify. Where reasonable diversification realistically cannot be achieved, the resultant concentration calls for capital levels higher than the regulatory minimums.

Concentrations generally are not inherently bad, but do add a dimension of risk which the management of the institution should consider when formulating plans and policies. In formulating these policies, management should, at a minimum, address goals for portfolio mix and limits within the loan and other asset categories. The institution's business strategy, management expertise and location should be considered when reviewing the policy. Management should also consider the need to track and monitor the economic and financial condition of specific geographic locations, industries and groups of borrowers in which the bank has invested heavily. All concentrations should be monitored closely by management and receive a more in-depth review than the diversified portions of the institution's assets. To establish a meaningful tracking system for concentrations of credit, financial institutions should be encouraged to consider the use of codes to track individual borrowers, related groups of borrowers, industries, and individual foreign countries. Financial institutions should also be encouraged to use the standard industrial classification (SIC) or similar code to track industry concentrations.

Refer to the Report of Examination Instructions for guidance in identifying and listing concentrations in the examination report.

VII. FEDERAL FUNDS SOLD AND REPURCHASE AGREEMENTS

Federal funds sold and securities purchased under agreement for resale represent convenient methods to employ excess funds to enhance earnings. Federal funds are excess reserve balances and take the form of a one-day transfer of funds between banks. These funds carry a specified rate of interest and are free of the risk of loss due to fluctuations in market prices entailed in buying and selling securities. However, these transactions are usually unsecured and therefore do entail potential credit risk. Securities purchased under agreement for resale represent an agreement between the buying and selling banks that stipulates the selling bank will buy back the securities sold at an agreed price at the expiration of a specified period of time.

Federal funds sold are not "risk free" as is often supposed, and the examiner will need to recognize the elements of risk involved in such transactions. While the selling of funds is on a one-day basis, these transactions may evolve into a continuing situation. This development is usually the result of liability management techniques whereby the buying bank attempts to utilize the acquired funds to support a rapid expansion of its loan-investment posture and as a means of enhancing profits. Of particular concern to the examiner is that, in many cases, the selling bank will automatically conclude that the buying bank's financial condition is above reproach without proper investigation and analysis. If this becomes the case, the selling bank may be taking an unacceptable risk unknowingly.

Another area of potential risk involves selling Federal funds to a bank which may be acting as an intermediary between the selling bank and the ultimate buying bank. In this instance, the intermediary bank is acting as agent with the true liability for repayment accruing to the third bank. Therefore, it is particularly important that the original selling bank be aware of this situation, ascertain the ultimate disposition of its funds, and be satisfied as to the creditworthiness of the ultimate buyer of the funds.

Clearly, the "risk free" philosophy regarding the sale of Federal funds is inappropriate. Selling banks must take the necessary steps to assure protection of their position. The examiner is charged with the responsibility of ascertaining that selling banks have implemented and adhered to policy directives in this regard to forestall any potentially hazardous situations.

Examiners should encourage management of banks engaged in selling Federal funds to implement a policy with respect to such activity. This policy should include consideration of such matters as the aggregate sum to be sold at any one time, the maximum amount to be sold to any one buyer, the maximum duration of time the bank will sell to any one buyer, a list of acceptable buyers, and the terms under which a sale will be made. As in any form of lending, thorough credit evaluation of the prospective purchaser, both before granting the credit extension and on a continuing basis, is a necessity. Such credit analysis should emphasize the borrower's ability to repay, the source of repayment, and alternative sources of repayment should the primary source fail to materialize. While sales of Federal funds are normally unsecured unless otherwise regulated by State statutes, and while collateral protection is no substitute for thorough credit review, the selling bank should consider the possibility of requiring security if sales agreements are entered into on a continuing basis for specific but extended periods of time, or for overnight transactions which have evolved into longer term sales. Where the decision is made to sell Federal funds on an unsecured basis, the selling bank should be able to present logical reasons for such action based on conclusions drawn from its credit analysis of the buyer and bearing in mind the potential risk involved.

A review of Federal funds sold between examinations may prompt examiners to broaden the scope of their analysis of such activity if the transactions are not being handled in accordance with sound practices as outlined above. Where the bank has not developed a formal policy regarding the sale of Federal funds or fails to conduct a credit analysis of the buyer prior to a sale and during a continuous sale of such funds, the matter should be discussed with management. In such discussion, it is incumbent upon examiners to inform management that their remarks are not intended to cast doubt upon the financial strength of any bank to whom Federal funds are sold. Rather, the intent is to advise the banker of the potential risks of such practices unless safeguards are developed. The need for policy formulation and credit review on all Federal funds sold should be reinforced via a comment on the Administration, Supervision, and Control schedule. Also, if Federal funds sold to any one buyer equals or exceeds 100% of the selling bank's Tier 1 Capital, it should be listed on the Concentrations schedule unless secured by U.S. Government securities. Based on the circumstances, the examiner should determine the appropriateness of additional comments regarding risk diversification.

Securities purchased under an agreement to resell are generally purchased at prevailing market rates of interest. The purchasing bank must keep in mind that the transaction merely represents another form of lending. Therefore, considerations normally associated with granting secured credit should be made. Repayment or repurchases by the selling bank is a major consideration, and the buying bank should satisfy itself that the selling bank will be able to generate the necessary funds to repurchase the securities on the prescribed date. Policy guidelines should limit the amount of money extended to one seller. Collateral coverage arrangements should be controlled by procedures similar to the safeguards used to control any type of liquid collateral. Securities held under such an arrangement should not be included in the bank's investment portfolio but should be reflected in the report of examination under the caption "Securities Purchased Under Agreements to Resell". Transactions of this nature do not require entries to the securities account of either bank with the selling bank continuing to collect all interest and transmit such payments to the buying bank.

VIII. FUNDAMENTAL LEGAL CONCEPTS AND DEFINITIONS

Laws and regulations that apply to credit extended by banks are more complicated and continually in a state of change. However, certain fundamental legal principles apply no matter how complex or innovative a lending transaction. To avoid needless litigation and ensure that each loan is a legally enforceable claim against the borrower or collateral, adherence to certain rules and prudent practices relating to loan transactions and documentation is essential. An important objective of the examiner's analysis of collateral and credit files is not only to obtain information about the loan, but also to determine if proper documentation procedures and practices are being utilized. While examiners are not expected to be experts on legal matters, it is important they be familiar with the Uniform Commercial Code (UCC) adopted by their respective states as well as other applicable State laws governing credit transactions. A good working knowledge of the various documents necessary to attain the desired collateral or secured position, and how those documents are to be used or handled in the jurisdiction relevant to the bank under examination, is also essential.

With adoption of the UCC in all states except Louisiana, the legal requirements of secured loan transactions have been substantially simplified and standardized under Article 9 of the UCC. Examiners should note that the following types of transaction are not covered by Article 9: security interest subject to any statute of the United States such as the Ship Mortgage Act; landlord's lien; lien given by statute or other rule of law for services or materials; transfer of a claim for wages, salary or other compensation of an employee; an equipment trust covering railway rolling stock; transfer of an interest or claim in or under any policy of insurance; a right represented by a judgment; sale of accounts or chattel paper when part of the sale of a business; any right of setoff; an interest in or lien of real estate; and a transfer in whole or in part of any deposit, savings passbook or like account.

Secured and Unsecured Transactions

In a secured transaction, the debtor assigns certain rights in specified property. This interest provides the creditor with security. That is, if the debt is not repaid, the creditor usually has the right to apply the proceeds from the sale of the property, or collateral, toward payment of the debt. In an unsecured transaction, the creditor has no interest in specific property of the debtor, but does have a general interest in all the debtor's property.

Attachment, Security Agreement and Security Interest

Three terms basic to secured transactions are attachment, security agreement and security interest. Attachment refers to that point when the creditor's legal rights in the debtor's property come into existence or "attach". This does not mean the creditor necessarily takes physical possession of the property, nor does it mean acquisition of ownership of the property. Rather, it means that before attachment, the borrower's property is free of any legal encumbrance, but after attachment, the property is legally bound by the creditor's security interest. In order for the creditor's security interest to attach, there must be a security agreement in which the debtor assigns the specified property to the creditor as security for the loan. A creditor's security interest can be possessory or nonpossessory, purchase money or nonpurchase money. A creditor with a possessory security interest takes physical possession of the collateral until the debt is repaid. The general rule is a bank must take possession of stocks and bonds to perfect a security interest therein. In a transaction involving a nonpossessory security interest, the debtor retains possession of the collateral. As the terms suggest, a creditor who provides funds so that the borrower may purchase the collateral may obtain a purchase money security interest in that collateral. Where the credit was not advanced to enable the debtor to obtain the collateral, the security interest may be described as nonpurchase money.

Conditions for Attachment - In a secured transaction, the creditor's security interest consists primarily of two limited rights, the right of foreclosure and the right of priority. These rights do not attach to the debtor's property until three conditions have been met, which may be satisfied in any order. First, both the creditor and debtor must agree the creditor's security interest is to attach to the collateral. If the creditor's security interest is to be nonpossessory, the security agreement must be in writing, signed by the debtor, and contain an adequate description of the collateral. If the creditor's security interest is to be possessory, the security agreement may be oral. Second, the debtor must own or otherwise acquire rights in the collateral offered as security. Third, the creditor gives the debtor value (ordinarily money) in exchange for the security interest in the debtor's property. The debtor's rights in a secured transaction hinge on the fact that, generally, the debtor is considered the general owner of the collateral if and until sold by the creditor after foreclosure. Thus, the debtor has the following four basic rights: (1) The right of redemption, or the right to extinguish the creditor's security interest by repaying the debt; (2) The right to expect reasonable care of the collateral; (3) The right to surplus (in the case where the creditor repossesses and sells the goods); and (4) The right to transfer ownership of the collateral.

Perfection - Once the creditor's security interest has
attached, a lien has been created and the loan is secured. However, the prudent creditor usually takes steps to further protect its interest vis-a-vis

other creditors by perfecting the security interest. This process in essence puts all other potential creditors on notice that certain of the debtor's property may be encumbered. The creditor should perfect its security interest as soon as possible after attachment because the creditor with the earliest perfected security interest generally has prior claim if the property must later be sold to pay the debt. Lien perfection can be effected by taking possession of the property, filing a copy of the security agreement or financing statement with the appropriate public official, or, in certain cases, by doing nothing. The determination as to whether filing is necessary in order to perfect a lien generally depends upon the type of collateral. Under the UCC, farm products, inventory, equipment and, in most instances, intangibles require filing in order to perfect the lien. Purchase money security interests in consumer goods and farm equipment require no filing (this applies to the latter only if the purchase price is $2,500 or less). A creditor can perfect by doing nothing only if the debtor is an "ultimate consumer", that is, has acquired the goods which serve as collateral for personal use. In cases where filing a copy of the security agreement or financing statement is required, the filing is good for a period of five years. The bank may file a continuation statement within six months prior to the end of the five-year period; if this is not done, the security interest lapses and its lien becomes unperfected. Filing a continuation statement continues the effectiveness of the original statement for another five-year period after the last date on which the filing was effective.

Examiners should determine bank policy concerning the checking of lien positions prior to advancing funds. Failure to perform this simple procedure may result in the bank unknowingly assuming a junior lien position and, thereby, greater potential loss exposure. Filing records may be checked by management personally or a lien search may be performed by the filing authority or other responsible party. This is especially important when new credit lines are granted by the bank.

Farm Products Lien Provision - The Food Security Act of 1985 (effective December 26, 1986) makes the "farm products exception" in the UCC available only if one of two possible procedures are followed. This exception provides that where the sale of farm products is concerned, a buyer acquires clear title to the farm products even if they are pledged as collateral to a loan unless one of two possible procedures are followed: (1) The state can establish a central filing system which meets the requirements of the legislation. If a bank properly files with the state under this system, its security interests in sold farm products will continue; or (2) The state may alternatively adopt a pre-notification system. Under this approach, a bank must notify potential buyers of farm products of its security interests.

The FDIC recognizes that liens do not have to be filed to create a legal security interest in collateral. Nevertheless, banks are encouraged to take every practicable measure to perfect their security interests as a normal prudent lending practice. This is true regardless of the type of collateral involved.
For farm products, additional costs are required to achieve lien perfection against all parties. Whether or not this extra cost should be incurred is a decision for bank management based on their perception of the value or importance of the incremental protection obtained.

The FDIC expects bankers, as a matter of normal prudence, to take reasonable precaution to protect their security interests in farm products even though absolute protection may not be practical. Traditional UCC filings should be recorded, and, if the state has established a central filing system, the bank's security interest should be recorded there as well. In most instances, when there is no central filing system, notification should be provided to the normal local buyers of whatever farm product is involved and those prospective buyers indicated by the borrower. Bank procedures should also include some periodic verification that the collateral is still in the borrower's possession and in acceptable condition. Also, deteriorating conditions or circumstances of a borrower may dictate buyer notification even though it was not considered necessary at origination of the loan.

In reviewing loans secured by farm products, examiners will consider a loan secured (as opposed to unsecured) if the bank has established a legal security interest in the collateral. Perfection of a lien always enhances the level of protection provided by the bank's lien. The importance of lien perfection to an examiner's assessment of the risk in any individual loan is a matter of judgment, influenced by all the other circumstances and facts surrounding the credit.

Special Filing Requirements - The proper filing office varies from state to state depending on whether filings are made on a local or state-wide basis or a combination thereof. A peculiarity common to all states is the filing of a lien on aircraft; the security agreement must be submitted to the Federal Aviation Administration in Oklahoma City, Oklahoma.

Default and Foreclosure - As a secured party, a bank's rights in collateral only come into play when the debtor is in default. What constitutes default varies according to the specific provisions of each promissory note, loan agreement, security agreement, or other related documents. After a debtor has defaulted, the creditor usually has the right to foreclose, which means the creditor seizes the security pledged to the loan, sells it and applies the proceeds to the unpaid balance of the loan. There may be more than one creditor claiming a right to the sale proceeds in foreclosure situations. When this occurs, priority is generally established as follows: (1) Creditors with a perfected security interest (in the order in which lien perfection was attained); (2) Creditors with an unperfected security interest; and (3) General creditors.

Under the UCC procedure for foreclosing security interests, four concepts are involved. First is repossession or taking physical possession of the collateral, which may be accomplished with judicial process or without judicial process (known as self-help repossession), so long as no breach of the peace is committed by the creditor. The former is usually initiated by a replevin action in which the sheriff seizes the collateral under court order. A second important concept of UCC foreclosure procedures is redemption or the debtor's right to redeem the security after it has been repossessed. Generally, the borrower must pay the entire balance of the debt plus all expenses incurred by the bank in repossessing and holding the collateral. The third concept is retention which allows the bank to retain the collateral in return for releasing the debtor from all further liability on the loan. The borrower must agree to this action, hence would likely be so motivated only when the value of the security is likely to be less than or about equal to the outstanding debt. Finally, if retention is not agreeable to both borrower and lender, the fourth concept, resale of the security, comes into play. Although sale of the collateral may be public or private, notice to the debtor and other secured parties must generally be given. The sale must be commercially reasonable in all respects. Debtors are entitled to any surplus resulting from sale price of the collateral less any unpaid debt. If a deficiency occurs (i.e., the proceeds from sale of the collateral were inadequate to fully extinguish the debt obligation), the bank has the right to sue the borrower for this shortfall. This is a right it does not have under the retention concept.

Exceptions to the Rule of Priority - There are three exceptions to the general rule that the creditor with the earliest perfected security interest has priority. The first concerns a specific secured transaction in which a creditor makes a loan to a dealer and takes a security interest in the dealer's inventory. Suppose such a creditor files a financing statement with the appropriate public official to perfect the security interest. While it might be possible for the dealer's customers to determine if an outstanding security interest already exists against the inventory, it would be impractical to do so. Therefore, an exception is made to the general rule and provides that a buyer in the ordinary course of business, i.e., an innocent purchaser for value who buys in the normal manner, cuts off a prior perfected security interest in the collateral.

The second exception to the rule of priority concerns the vulnerability of security interests perfected by doing nothing. While these interests are perfected automatically, with the date of perfection being the date of attachment, they are extremely vulnerable at the hands of subsequent bona fide purchasers. Suppose, for example, a dealer sells a television set on a secured basis to an ultimate consumer. Since the collateral is consumer goods, the security interest is perfected the moment if attaches. But if the original buyer sells the televison set to another person who buys it in good faith and in ignorance of the outstanding security interest, the UCC provides that the subsequent purchase cuts off the dealer's security interest. This second exception is much the same as the first except for one important difference: the dealer (creditor) in this case can be protected against purchase of a customer's collateral by filing a financing statement with the appropriate public official.

The third exception regards the after-acquired property clause which protects the value of the collateral in which the creditor has a perfected security interest. The after-acquired property clause ordinarily gives the original creditor senior priority over creditors with later perfected interests. However, it is waived as regards the creditor who supplies replacements or additions to the collateral or the artisan who supplies materials and services which enhance the value of the collateral as long as a perfected security interest in the replacement or additions, or collateral is held.

Borrowing Authorization

Borrowing authorizations in essense permit one party to incur liability for another. In the context of lending, this usually concerns corporations. A corporation may enter into contracts within the scope of the powers authorized by its charter. In order to make binding contracts on behalf of the corporation, the officers must be authorized to do so either by the board of directors or by expressed or implied general powers. Usually a special resolution expressly gives certain officers the right to obligate the corporate entity, pledge assets as collateral, agree to other terms of the indebtedness and sign all necessary documentation on behalf of the corporate entity.

Although a general resolution is perhaps satisfactory for the short-term, unsecured borrowings of a corporation, a specific resolution of the corporation's board of directors is generally advisable to authorize such transactions as term loans, loans secured by security interests in the corporation's personal property, or mortgages on real estate. Further, mortgaging or pledging substantially all of the corporation's assets without prior approval of the shareholders of the corporation is often prohibited, therefore, a bank may need to seek advice of counsel to determine if shareholder consent is required for certain contemplated transactions.

Loans to corporations should indicate on their face that the corporation is the borrower. The corporate name should appear followed by the name, title and signature of the appropriate officer. If the writing is a negotiable instrument, the UCC states the party signing is personally liable as a general rule. To enforce payment against a corporation, the note or other writing should clearly show that the debtor is a corporation.

Participation Agreement

Because of restrictions on the amount of credit a bank may extend to any one borrower, there has developed the practice of a bank selling or participating part of its loan to another bank in order to satisfy the credit needs of the borrower. This is called a "participation" and there are a number of ways it may occur. The customary method is that the borrower signs a note at the lead bank which then sells an interest in the note to one or more banks pursuant to the terms of a participation agreement. The agreement should spell out in detail all terms, conditions and understandings between the lead bank and the participant(s). The participation agreement ordinarily establishes which party is paid first, what happens in the event of default, how setoffs received by either bank are to be treated, how various expenses are to be divided, and who is responsible to collect the note in the event of default. At the time a lead bank sells an interest in the loan, it must fully disclose to the participating bank information in its possession concerning the borrower. If not, it may be liable to the participating bank for any loss suffered by the latter in the event of default.

Bond and Stock Powers

As mentioned previously, a bank generally obtains a security interest in stocks and bonds by possession. The documents which allow the bank to sell the securities if the borrower defaults are called stock powers and bond powers. The examiner should ensure the bank has, for each borrower who has pledged stocks or bonds, one signed stock power for all stock certificates of a single issuer, and a separate signed bond power for each bond instrument. The signature must agree with the name on the actual stock certificate or bond instrument.

Comaker

Two or more persons who are parties to a contract or promise to pay are known as comakers. They are a unit to the performance of one act and are considered primarily liable. In the case of default on an unsecured loan, a judgment would be obtained against all. A release against one is a release against all because there is but one obligation and if that obligation is released as to one obligor, it is released as to all others.

Loan Guarantee

Since banks often condition credit advances upon the backup support provided by third party guarantees, examiners should understand the legal fundamentals governing guarantees. A guarantee may be a guarantee of payment or of collection. "Payment guaranteed" or equivalent words added to a signature means that if the instrument is not paid when due, the guarantor will pay it according to its terms without resort by the holder to any other party. "Collection guaranteed" or equivalent words added to a signature means that if the instrument is not paid when due, the guarantor will pay it, but only after the holder has reduced to judgment a claim against the maker and execution has been returned unsatisfied, or after the maker has become insolvent or it is otherwise useless to proceed against such a party.

Contracts of guarantee are further divided into a limited guarantee which relates to a specific note (often referred to as an "endorsement") or for a fixed period of time, or a continuing guarantee which, in contrast, is represented by a separate instrument and enforceable for future (duration depends upon State law) transactions between the bank and the borrower or until revoked. A well drawn continuing guarantee contains language substantially similar to the following: "This is an absolute and unconditional guarantee of payment, is unconditionally delivered, and is not subject to the procurement of a guarantee from any person other than the undersigned, or to the performance or happening of any other condition." The aforementioned unambiguous terms are necessary to the enforceability of contracts of guarantee, as they are frequently entered into solely as an accommodation for the borrower and without the guarantor's participation in the benefits of the loan. Thus, courts tend to construe contracts of guarantee strictly against the party claiming under the contract. Unless the guarantee is given prior to or at the time the initial loan is made, the guarantee may not be enforceable because of the difficulty of establishing that consideration was given. Banks should not disburse funds on such loans until they have the executed guarantee agreement in their possession. Banks should also require the guarantee be signed in the presence of the loan officer, or, alternatively, that the guarantor's signature be notarized. If the proposed guarantor is a partnership, joint venture, or corporation, the examiner should ensure the signing party has the legal authority to enter into the guarantee agreement. Whenever there is a question concerning a corporation's authority to guarantee a loan, counsel should be consulted and a special corporate resolution passed by the organization's board of directors.

Subordination Agreement

A bank extending credit to a closely held corporation may want to have the company's officers and shareholders subordinate to the bank's loan any indebtedness owed them by the corporation. This is accomplished by execution of a subordination agreement by the officers and shareholders. Subordination agreements are also commonly referred to as standby ageements. Their basic purpose is to prevent diversion of funds from reduction of bank debt to reduction of advances made by the firm's owners or officers.

Hypothecation Agreement

This is an agreement whereby the owner of property grants a security interest in collateral to the bank to secure the indebtedness of a third party. Banks often take possession of the stock certificates, plus stock powers endorsed in blank, in lieu of a hypothecation agreement. Caution, however, dictates that the bank take a hypothecation agreement setting forth the bank's rights in the event of default.

Real Estate Mortgage

A mortgage may be defined as a conveyance of realty given with the intention of providing security for the payment of debt. There are several different types of mortgage instruments but those commonly encountered are regular mortgages, deeds of trust, equitable mortgages, and deeds absolute given as security.

Regular Mortgages - The regular mortgage involves only two parties, the borrower and the lender. The mortgage document encountered in many states today is referred to as the regular mortgage. It is, in form, a deed or conveyance of realty by the borrower to the lender followed or preceded by a description of the debt and the property, and includes a provision to the effect that the mortgage be released upon full payment of the debt. Content of additional paragraphs and provisions varies considerably.

Deeds of Trust - In the trust deed, also known as the deed of trust, the borrower conveys the realty not to the lender but to a third party, a trustee, in trust for the benefit of the holder of the notes(s) that constitutes the mortgage debt. The deed of trust form of mortgage has certain advantages, the principle being that in a number of states it can be foreclosed by trustee's sale under the power of sale clause without court proceedings.

Equitable Mortgages - As a general rule, any instrument in writing by which the parties show their intention that realty be held as security for the payment of a debt, constitutes an equitable mortgage capable of being foreclosed in a court of equity.

Deeds Absolute Given as Security - Landowners who borrow money may give as security an absolute deed to the land. "Absolute deed" means a quitclaim or warranty deed such as is used in an ordinary realty sale. On its face, the transaction appears to be a sale of the realty, however, the courts treat such a deed as a mortgage where the evidence shows that the instrument was really intended only as security for a debt. If such proof is available, the borrower is entitled to pay the debt and demand reconveyance from the lender, as in the case of an ordinary mortgage. If the debt is not paid, the grantee must foreclose as if a regular mortgage had been made.

The examiner should ensure the bank has performed a title and lien search of the property prior to taking a mortgage or advancing funds. Proper procedure calls for an abstractor bringing the abstract up to date, and review of the abstract by an attorney or title insurance company. If an attorney performs the task, the abstract will be examined and an opinion prepared indicating in whom title rests, along with any defects and encumbrances disclosed by the abstract. Like an abstractor, an attorney is liable only for damages occasioned by negligence. If a title insurance company performs the task of reviewing the abstract, it does essentially the same thing, however, when title insurance is obtained, it represents a contract to make good, loss arising through defects in title to real estate or liens or encumbrances thereon. Title insurance covers various items not covered in an abstract and title opinion. Some of the more common are errors by abstractors or attorneys, unauthorized corporate action, mistaken legal interpretations, and unintentional errors in public records by public officials. Once the bank determines title and lien status of the property, the mortgage can be prepared and funds advanced. The bank should record the mortgage immediately after closing the loan. Form, execution, and recording of mortgages varies from state to state and therefore must conform to the requirements of State law.

Collateral Assignment

An assignment is generally considered as the transfer of a legal right from one person to another. The rights acquired under a contract may be assigned if they relate to money or property, but personal services may not be assigned. Collateral assignments are used to establish the bank's rights as lender in the property or asset serving as collateral. It is generally used for loans secured by savings deposits, certificates of deposit or other cash accounts as well as loans backed by cash surrender value of life insurance. In some instances, it is used in financing accounts receivable and contracts. If a third party holder of the collateral is involved, such as life insurance company or the payor of an assigned contract, an acknowledgement should be obtained from that party as to the bank's assigned interest in the asset for collateral purposes.

IX. CONSIDERATION OF BANKRUPTCY LAW AS IT RELATES TO COLLECTABILITY OF A DEBT

Introduction

Familiarity with the basic terms and concepts of the Federal bankruptcy law (formally known as the Bankruptcy Reform Act of 1978) is necessary in order for examiners to make informed judgments concerning the likelihood of collection of loans to bankrupt individuals or organizations. It must be stressed the following paragraphs present only an overview of the subject. Complex situations may arise where more in-depth consideration of the bankruptcy provisions may be necessary and warrant consultation with the bank's attorney, Regional Counsel or other member of the Regional Office staff. For the most part, however, knowledge of the following information when coupled with review of credit file data and discussion with bank management should enable examiners to reach sound conclusions as to the eventual repayment of the bank's loans.

Forms of Bankruptcy Relief

Liquidation and rehabilitation are the two basic types of bankruptcy proceedings. Liquidation is pursued under Chapter 7 of the law and involves the bankruptcy trustee collecting all of the debtor's nonexempt property, converting it into cash and distributing the proceeds among the debtor's creditors. In return, the debtor obtains a discharge of all debts outstanding at the time the petition was filed which releases the debtor from all liability for those pre-bankruptcy debts.

Rehabilitation (sometimes known as reorganization) is effected through Chapter 11 or Chapter 13 of the law and in essence provides that creditors' claims are satisfied not via liquidation of the obligor's assets but rather from future earnings. That is, debtors are allowed to retain their assets but their obligations are restructured and a plan is implemented whereby creditors may be paid.

Chapter 11 bankruptcy is available to all debtors, whether individuals, corporations or partnerships. Chapter 13 (sometimes referred to as the "wage earner plan"), on the other hand, may be used only by individuals with regular incomes and when their unsecured debts are under $100,000 and secured debts less than $350,000. The aforementioned rehabilitation plan is essentially a contract between the debtor and the creditors. Before the plan may be confirmed, the bankruptcy court must find it has been proposed in good faith and that creditors will receive an amount at least equal to what would be received in a Chapter 7 proceeding. In a Chapter 11 reorganization, all creditors are entitled to vote on whether or not to accept the repayment plan. In Chapter 13 proceedings, only secured creditors are so entitled. A majority vote binds the minority to the plan, provided the latter will receive pursuant to the plan at least the amount they would have received in a straight liquidation. The plan is fashioned so that it may be carried out in three years although the court may extend this to five years.

Most cases in bankruptcy courts are Chapter 7 proceedings, but reorganization cases are increasingly common. From the creditor's point of view, Chapter 11 or 13 filings generally result in greater debt recovery than do liquidation situations under Chapter 7. Nonetheless, the fact that reorganization plans are tailored to the facts and circumstances applicable to each bankrupt situation means that they vary considerably and the amount recovered by the creditor may similarly vary from nominal to virtually complete recovery.

Functions of Bankruptcy Trustees

Trustees are selected by the borrower's creditors and are responsible for administering the affairs of the bankrupt debtor's estate. The bankrupt's property may be viewed as a trust for the benefit of the creditors, consequently it follows the latter should, through their elected representatives, exercise substantial control over this property.

Voluntary and Involuntary Bankruptcy

When a debtor files a bankruptcy petition with the court, the case is described as a voluntary one. It is not necessary the individual or organization be insolvent in order to file a voluntary case. Creditors may also file a petition, in which case the proceeding is know as an involuntary bankruptcy. However, this alternative applies only to Chapter 7 cases and the debtor generally must be insolvent, i.e., unable to pay debts as they mature, in order for an involuntary bankruptcy to be filed.

Automatic Stay

Filing of the bankruptcy petition requires (with limited exceptions) creditors to stop or "stay" further action to collect their claims or enforce their liens or judgements. Actions to accelerate, set off or otherwise collect the debt are prohibited once the petition is filed, as are post-bankruptcy contacts with the obligor (such as "dunning" letters). The stay remains in effect until the debtor's property is released from the estate, the bankruptcy case is dismissed, the debtor obtains or is denied a discharge, or the bankruptcy court approves a creditor's request for termination of the stay. Two of the more important grounds applicable to secured creditors under which they may request termination are as follows: (1) The debtor has no equity in the encumbered property, and the property is not necessary to an effective rehabilitation plan; or (2) The creditor's interest in the secured property is not adequately protected. In the latter case, the law provides three methods by which the creditor's interests may be adequately protected: the creditor may receive periodic payments equal to the decrease in value of the creditor's interest in the collateral; or an additional or substitute lien on other property may be obtained; or some other protection is arranged (e.g., a guarantee by a third party) to adequately safeguard the creditor's interests. If these alternatives result in the secured creditor being adequately protected, relief from the automatic stay will not be granted. If relief from the stay is obtained, creditors may continue to press their claims upon the bankrupt's property free from interference by the debtor or the bankruptcy court.

Property of the Estate

When a borrower files a bankruptcy petition, an "estate" is created and, under Chapter 7 of the law, the property of the estate is passed to the trustee for distribution to the creditors. Certain of the debtor's property is exempt from distribution under all provisions of the law (not just Chapter 7), as follows: homeowner's equity up to $7,500; automobile equity and household items up to $1,200; jewelry up to $500; cash surrender value of life insurance up to $4,000; Social Security benefits (unlimited); and miscellaneous items up to $400 plus any unused portion of the homeowner's equity. The bankruptcy code recognizes a greater amount of exemptions may be available under State law and, if State law is silent or unless it provides to the contrary, the debtor is given the option of electing either the Federal or State exemptions. Examiners should note that some liens on exempt property which would otherwise be enforceable are rendered unenforeceable by the bankruptcy. A secured lender may thus become unsecured with respect to the exempt property. The basic rule in these situations is that the debtor can render unenforceable judicial liens on any exempt property and security interests that are both nonpurchase money and nonpossessory on certain household goods, tools of the trade and health aids.

Discharge and Objections to Discharge

The discharge, as mentioned previously, protects the debtor from further liability on the debts discharged. Sometimes, however, a debtor is not discharged at all (i.e., the creditor has successfully obtained an "objection to discharge") or is discharged only as regards a specific creditor(s) and a specific debt(s) (an action known as "exception to discharge"). The borrower obviously remains liable for all obligations not discharged, and creditors may pursue customary collection procedures with respect thereto. Grounds for an "objection to discharge" include the following actions or inactions by the bankrupt debtor (this is not an all-inclusive list): fraudulent conveyance within 12 months of filing the petition; unjustifiable failure to keep or preserve financial records; false oath or account or presentation of a false claim in the bankruptcy case and estate, respectively; withholding of books or records from the trustee; failure to satisfactorily explain any loss or deficiency of assets; refusal to testify when legally required to do so; and receiving a discharge in bankruptcy within the last six full years. Some of the bases upon which creditors may file "exceptions to discharge" are: nonpayment of income taxes for the three years preceding the bankruptcy; money, property or services obtained through fraud, false pretenses or false representation; debts not scheduled on the bankruptcy petition and which the creditor had no notice; alimony or child support payments (this exception may be asserted only by the debtor's spouse or children, property settlements are dischargeable); and submission of false or incomplete financial statements. If a bank attempts to seek an exception on the basis of false financial information, it must prove the written financial statement was materially false, it reasonably relied on the statement, and the debtor intended to deceive the bank. These assertions can be difficult to prove. Discharges are unavailable to corporations or partnerships. Therefore, after a bankruptcy, corporations and partnerships often dissolve or become defunct.

Reaffirmation

Debtors sometimes promise their creditors after a bankruptcy discharge that they will repay a discharged debt. An example wherein a debtor may be so motivated involves the home mortgage. To keep the home and discourage the mortgagee from foreclosing, a debtor may reaffirm this obligation. This process of reaffirmation is an agreement enforceable through the judicial system. The law sets forth these basic limitations on reaffirmations: the agreement must be signed before the discharge is granted; a hearing is held and the bankruptcy judge informs the borrower there is no requirement to reaffirm; and the debtor has the right to rescind the reaffirmation if such action is taken within 30 days.

Classes of Creditors

The first class of creditors is known as priority creditors. As the name implies, these creditors are entitled to receive payment prior to any others. Priority payments include administrative expenses of the debtor's estate, unsecured claims for wages and salaries up to $2,000 per person, unsecured claims for employee benefit plans, unsecured claims of individuals up to $900 each for deposits in conjunction with rental or lease of property, unsecured claims of governmental units and certain tax liabilities. Secured creditors are only secured up to the extent of the value of their collateral. They become unsecured in the amount by which collateral is insufficient to satisfy the claim. Unsecured creditors are of course the last class in terms of priority.

Preferences

An important objective of the Bankruptcy Reform Act of 1978 is to achieve equality of distribution among classes of creditors. Consequently, certain actions taken by a creditor before or during bankruptcy proceedings may be invalidated by the trustee if they result in certain creditors receiving more than their share of the debtor's estate. These actions are called "transfers" and fall into two categories. The first involves absolute transfers, such as payments received by a creditor; the trustee may invalidate this action and require the payment be returned and made the property of the bankrupt estate. A transfer of security, such as the granting of a mortgage, may also be invalidated by the trustee. Hence, the trustee may require previously encumbered property be made unencumbered, in which case the secured party becomes an unsecured creditor. This has obvious implications as regards loan collectability.

Preferences are a potentially troublesome area for banks and examiners should have an understanding of basic principles applicable to them. Some of the more important of these are listed here. (1) A preference may be invalidated (also known as "avoided") if it has all of these elements: the transfer was to or for the benefit of a creditor; the transfer was made for or on account of a debt already outstanding; the transfer has the effect of increasing the amount a creditor would receive in Chapter 7 proceedings; the transfer was made within 90 days of the bankruptcy filing, or within one year if the transfer was to an insider who had reasonable cause to believe the debtor was insolvent at the time of transfer; and the debtor was insolvent at the time of the transfer. Under bankruptcy law, borrowers are presumed insolvent for 90 days prior to filing the bankruptcy petition. (2) Payment to a fully secured creditor is not a preference because such a transfer would not have the effect of increasing the amount the creditor would otherwise receive in a Chapter 7 proceeding. Payment to a partially secured creditor does, however, have the effect of increasing the creditor's share and is thus deemed a preference which the trustee may avoid. (3) Preference rules also apply to a transfer of a lien to secure past debts, if the transfer has all five elements set forth under (1). (4) There are certain situations wherein a debtor has given a preference to a creditor but the trustee is not permitted to invalidate it. A common example concerns floating liens on inventory under the Uniform Commercial Code. These matters are subject to complex rules, however, and consultation with the Regional Office may be advisable when this issue arises.

Setoffs

Setoffs occur when a party is both a creditor and a debtor of another; amounts which a party owes are netted against amounts which are owed to that party. If a bank exercises its right of setoff properly and before the bankruptcy filing, the action is generally upheld in the bankruptcy proceedings. Setoffs made after the bankruptcy may also be valid but certain requirements must be met of which the following are especially important: First, the debts must be between the same parties in the same right and capacity. For example, it would be improper for the bank to set off the debtor's loan against a checking account of the estate of the obligor's father, of which the debtor is executor. Second, both the debt and the deposit must precede the bankruptcy petition filing. Third, the setoff may be disallowed if funds were deposited in the bank within 90 days of the bankruptcy filing and for the purpose of creating or increasing the amount to be set off.

Transfers Not Timely Perfected or Recorded

Under most circumstances, a bank which has not recorded its mortgage or otherwise fails to perfect its security interest in a proper timely manner, runs great risk of losing its security. This is a complex area of the law but prudence clearly dictates that liens be properly obtained and timely filed so that the possibility of losing the protection provided by collateral is eliminated.